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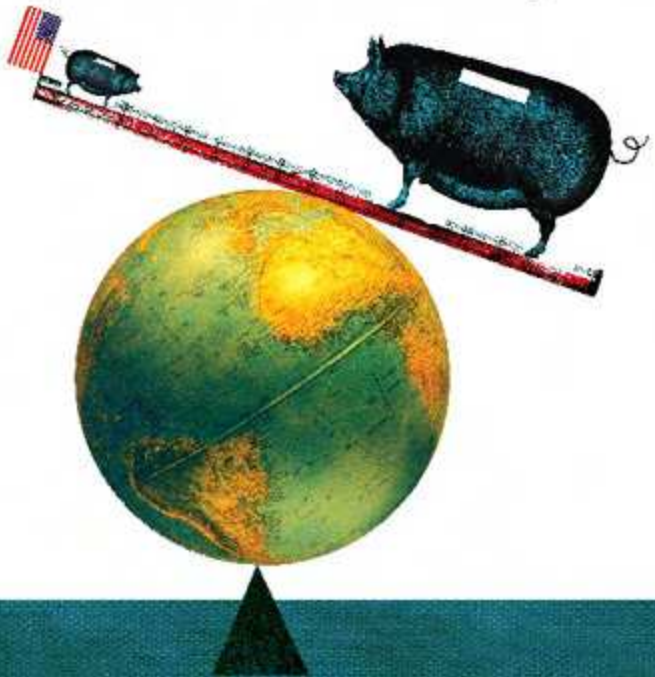
Special issue on the world economy



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Politics this week

Sep 22nd 2005
From The Economist print edition

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Another hurricane

The reconstruction of **New Orleans** was upset by the approach of Hurricane Rita. Upgraded to a category 5 storm, the same as Katrina, Rita was on course to hit Texas, with Louisiana also under threat. Meanwhile, the death-toll for Katrina climbed past 1,000.

Addressing the nation, George Bush vowed that the federal government would help New Orleans, even though the total amount needed is estimated at $200 billion. He called for an **urban homesteading act**, giving away federal land to people prepared to build their own homes.

See article

Arnold Schwarzenegger said he would run for re-election as California's governor; he also backed a proposition to require public-sector unions to get their members' written permission to use their dues for political purposes.

The Democratic minority leader in the Senate, Harry Reid, announced he would not support **John Roberts's** confirmation to the Supreme Court; the conservative judge still seemed likely to become chief justice.

Germany was in turmoil after its two main parties fought almost to a dead-heat in a general election: the centre-right Christian Democrats, led by Angela Merkel, just won, with 35.2% of the votes and 225 seats, while the incumbent chancellor, Gerhard Schröder, and his Social Democrats, got 34.3% and 222 seats. The liberal Free Democrats, the newly-formed Left Party and the Greens all got under 10%. No combination looked assured of power; a “grand coalition” of the two leading parties was mooted.

See article

Italy's economy minister, Domenico Siniscalco, tried to resign over the government's failure to oust the central bank governor, Antonio Fazio.

See article

The European Union, **Turkey** and the internationally recognised (ie, Greek-Cypriot) republic of **Cyprus** argued over whether Turkey should start negotiations for full membership of the European club as scheduled on October 3rd. The Greek-Cypriots insist that the Turks should recognise their country first; the Turks say no.

Lithuania's authorities detained a Russian pilot after he ejected from his jet, which crashed after apparently violating Lithuanian airspace.

Britain's turn in Iraq

Reuters

The focus in **Iraq** switched from Baghdad to Basra, the biggest city in the south, where tension rose between British forces, the local authorities and various militias competing for power. British troops stormed a police station in a bid to rescue two British soldiers who had been arrested by Iraqi police and handed over to a militia. In another incident, a mob set fire to a British military vehicle, raising questions in Britain about whether its troops should stay.

See article

After a defiant speech by **Iran's** president at the UN, his chief nuclear negotiator threatened to end all co-operation with inspectors from the International Atomic Energy Agency, the UN's nuclear watchdog, and start enriching uranium, if the agency's 35-nation board reported Iran's past nuclear rule-breaking this week to the UN Security Council. A majority of the board seemed ready to refer Iran to the Council, but a number of countries, including Russia, argued against it.

See article

The Egyptian government and the Palestinian Authority tried to persuade Israel to let a third party monitor the main crossing point between Egypt and the Gaza strip, which thousands of **Gazans** surged across last week.

See article

The UN Security Council extended the mandate of the UN peacekeeping force (now 15,000-strong) in **Liberia** by six months, though the UN's secretary-general, Kofi Annan, had asked for a one-year renewal. The first general election since a 14-year-long civil war ended in 2003 is due next month.

Separatists in **Nigeria's** oil-rich Niger Delta region threatened to attack oil installations unless their leader, Mujahid Dokubu-Asari, who was arrested this week, is freed.

After a row over who should control the oil ministry, **Sudan's** president, Omar Bashir, announced a unity government with former rebels from the south as part of a peace accord reached earlier this year. Northerners are to keep control of the defence, interior and finance ministries; the ruling National Congress Party has 16 of 29 posts, while the main southern group is to have nine.

Tricky times for Lula

More trouble for **Brazil's** president, Luiz Inácio Lula da Silva. In elections in his Workers' Party, whose leaders have been embroiled in a corruption scandal, his candidate for party president failed to secure an outright victory, and faces a run-off against a candidate from the party's left. Meanwhile, the conservative president of Congress's lower house resigned over an unrelated bribery scam.

See article

The United States “decertified” **Venezuela**, saying that its leftist government had failed to fight drugs. George Bush's administration said it would still finance opposition activity in the country,

such as election monitoring. Meanwhile, Venezuela's president, Hugo Chávez, said he was cancelling all mining permits and would award no new ones to foreign companies.

See article

Mexico's public-security minister was killed when his helicopter crashed into a mountain in fog. The minister was a close aide to President Vicente Fox and a key figure in the government's campaign against violent drug gangs.

Nuclear confusion

Six-country talks aimed at ending the crisis caused by **North Korea**'s efforts to acquire nuclear weapons seemed to make a breakthrough. But within a day it became clear that serious issues, including North Korea's demand for a nuclear power station, remained unresolved.

See article

Japan's main opposition party, the Democratic Party of Japan, chose a youthful foreign-policy expert, Seiji Maehara, as its new leader, following the party's disastrous defeat in an election this month.

See article

New Zealand's Labour prime minister, Helen Clark, hoped to retain power after early results gave her victory in an election this month. But she will need the support of smaller parties.

Reuters

See article

A general election was also held in **Afghanistan**; results are not expected for three weeks, but the new parliament has limited powers and may be fragmented.

See article

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Business this week

Sep 22nd 2005
From The Economist print edition

Oil prices rise

In the face of rising oil prices, **OPEC** temporarily suspended its oil-output quotas for the fourth quarter. But the move, intended to reassure markets, is unlikely to affect prices very much. Meanwhile, markets were watching the next big storm, Hurricane Rita, a category 5 storm that was expected to hit America's Gulf coast at the weekend. The price of crude shot to near $68 a barrel in New York. Stocks fell as oil companies shut refineries and evacuated their workers in the Gulf.

See article

In its semi-annual *World Economic Outlook*, the IMF raised its **oil-price forecast** for 2006 to $61.75 per barrel from $43.75 per barrel previously. Some governments may need to adjust consumption subsidies, the IMF said.

See article

Seeking more speed and flexibility in the face of nimble rivals, **Microsoft** announced a restructuring that will realign its seven business units into three big divisions, each with its own president. The big software firm, embarrassed by the delayed release of a new version of its Windows operating system, has been stung by charges that it is too bureaucratic. Meanwhile, Microsoft and **AOL** both said they will offer Internet phone services.

See article

Sony revamp

Sony announced that it will cut 10,000 jobs or roughly 7% of its global workforce, in an effort to restore the company's profitability. The company will also close or sell 11 of its 65 manufacturing plants. Sony shares have lost two-thirds of their value over the last five years, as the company has struggled to keep pace with new developments in portable music and flat-screen televisions. The restructuring follows the appointment in March of Sir Howard Stringer, as the group's first foreign chief executive.

In a further sign of the tough climate for white-collar criminals in America, the former chief executive and finance officer of **Tyco International** were sentenced to up to 25 years in prison. Dennis Kozlowski and Mark Swartz had been found guilty in June of grand larceny, securities fraud and other charges. The sentencing appears to extend a trend that has also resulted in long prison terms for officials at WorldCom and Adelphia Communications.

The former president of Hollinger International struck a **plea bargain** with American prosecutors. David Radler, once a key advisor to Conrad Black, pleaded guilty to mail fraud and agreed to

testify against others in the case. He agreed to a 29-month prison sentence and a $250,000 fine. Six other charges were dropped.

An American judge approved legal settlements that will return more than $6.1 billion to investors who lost money in the **WorldCom** accounting scandal. About 830,000 people and institutions will benefit. The money will come from a variety of defendants. Citigroup and J.P. Morgan Chase, which underwrote or traded WorldCom securities, will each pay $2 billion or more.

Goldman Sachs said its third-quarter earnings surged by 84% from a year earlier, to a record $1.6 billion. Returns in trading and investment banking were especially good. The firm also announced a $7.1 billion stock buyback, which Thomson Financial called the largest yet among investment banks.

Not everyone on Wall Street did so well. **Morgan Stanley** posted higher quarterly earnings before a $1 billion charge for the sale of its aircraft-leasing business, but net profit for the quarter fell 83%. The investment firm was also hit by an increase in severance costs for ex-managers.

Fee cuts

British fund managers could find themselves in a price war after **Fidelity** slashed annual management fees on its main index-tracking fund. The big fund-management group cut the charge on its £277m ($498m) FTSE All-Share tracker fund to 0.1% from 0.5%.

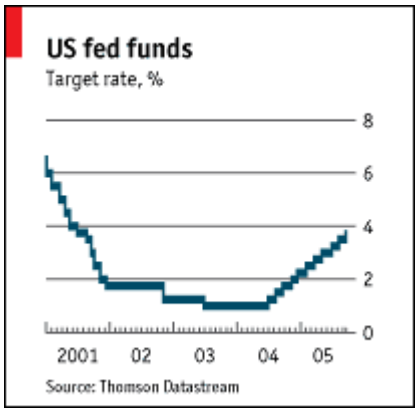
See article

Kate Moss, a British model, lost several advertising contracts after a photo of her allegedly sniffing cocaine appeared in a newspaper. H&M, a Swedish retailer, was the first to drop Ms Moss, swiftly followed by Burberry and Chanel.

Gazprom, the Russian gas monopoly, borrowed $12 billion from western banks, reportedly to take over Sibneft. If completed it would be Russia's biggest takeover. Gazprom shares rose on the news.

America's Federal Reserve raised **interest rates** for the 11th consecutive time, citing risks of inflation. The short-term interest-rate target was bumped up to 3.75% from 3.5%. The Fed indicated that it expects to continue raising the rate at a "measured" pace. Inflation worries apparently overshadowed the concerns that devastation from Hurricane Katrina might have dampened growth in the country's economy.

See article



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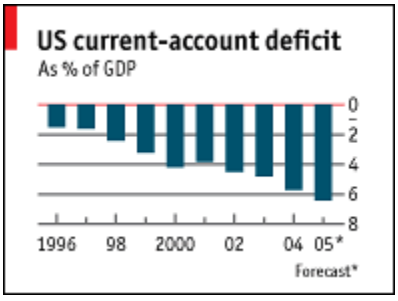
Economist.com OPINION

The world economy

Restoring the balance

Sep 22nd 2005
From The Economist print edition

The world economy is still growing rapidly, but is also out of kilter



IS THE world economy in good or bad shape? Judged by the pace of growth, it is in rude health. Despite soaring oil prices, the IMF's latest *World Economic Outlook* reckons that global output will grow by 4.3% both this year and next, well above its trend rate. But by other measures, the risks are also growing. Inflation is picking up. America's current-account deficit is now above 6% of GDP, an eye-watering level. And with the saving rate of American households now negative, consumers there look ever more financially stretched. The world economy, in short, is both surprisingly buoyant and worryingly imbalanced.

As a result, the outlook is more uncertain than the healthy rate of global growth indicates. Some big sources of today's growth are ultimately unsustainable because even America's consumers cannot forever spend more than their income, nor America's foreign borrowing rise indefinitely. Eventually, global balance must be restored through slower spending-growth in America compared with that in the rest of the world. But no one is sure where the limits lie, nor how painful the ultimate adjustment will be. Will American consumers slow their spending first, or will foreigners first tire of lending America money? Will the shifts be sudden or gradual? And will spending elsewhere pick up the slack?

Eyeball to eyeball

Many people are worried that foreigners will blink first—because investors lose their appetite for American assets or because Asia's central banks stop buying dollars on such a huge scale. Either development could send the dollar crashing. Given the size of America's borrowing, these are indeed risks. But they seem smaller than the possibility that America's consumers will blink first.

The foundations underpinning American spending—especially soaring house prices—are becoming ever more shaky. And in recent weeks these shaky foundations have been jolted not only by a hurricane and sharply higher fuel costs, but by a subtle yet dangerous shift in America's macroeconomic mix towards higher inflation, higher interest rates and looser fiscal policy.

According to the University of Michigan's survey of consumers, they expect inflation rates over the next five to ten years to jump above 3% for the first time in four years (see article). The Federal Reserve raised short-term interest rates by 0.25 percentage points on September 20th, bringing the federal funds rate to 3.75%. Its accompanying statement hinted that the Fed's governors too are more worried about prices than growth, suggesting more rises to come. Fears of higher inflation could become worse if the federal government goes on a spending binge. Thanks to George Bush's promise to spend “what it takes” to rebuild the Gulf coast, America's budget deficit seems certain to grow rapidly. In the short term, government spending will boost the economy,

but that effect could easily be outweighed by higher interest rates.

All these factors suggest that the growth in consumer spending is set to slow. Less clear is whether it will slow gradually (which is exactly what the world economy needs) or stall (which could send the world economy wobbling). By themselves, today's fuel prices will slow consumer spending, but will not send it tumbling. After all, Americans have shrugged off higher fuel costs for two years. But with petroleum stocks so low, fuel prices could well rise further. As *The Economist* went to press, Hurricane Rita was headed straight for Houston, Texas, a centre of America's already battered oil industry.

And yet a bigger worry is not just a reaction to higher fuel prices, but a broader loss of consumer confidence. There are signs that American consumers are jittery. A widely-watched index of consumer confidence plunged in September. Not only could falling confidence prick the housing bubble, but flatter house prices would themselves hurt consumer spending. In Australia and Britain, for instance, consumer confidence fell and spending slowed when house prices stopped rising. America's experience may prove different, but a slowdown in spending seems all too plausible.

Addicted to American demand

The impact of this on the world economy depends on whether foreign demand picks up the slack. America's soaring external deficits have been financed by rising surpluses elsewhere. These surpluses have sparked talk of a “global saving glut”. In fact, the appearance of a glut has more to do with a lack of investment demand abroad than a rise in saving, but there is little to suggest that the behaviour behind these surpluses will change overnight (see article).

In fact, some big economies, particularly China's and Germany's, are becoming more, not less, dependent on exports. With its domestic economy moribund, Germany's current-account surplus is likely to top 4% of GDP this year. Despite the messy outcome of its election this week, Germany's need for growth-inducing economic reforms is more urgent than ever.

China's current-account surplus, already 4.2% of GDP in 2004, has soared this year. Although China's leaders talk a lot about shifting their economy from exports towards domestic consumption, they need to do much more to make that happen. And oil exporting countries, who as a group are now the biggest counterparts to America's external deficits, are keener to build up large surpluses than to boost investment at home.

There are bright spots, notably Japan, still the country with the single biggest current-account surplus. After a decade of stagnation, its economy seems truly on the mend, with a domestically-rooted recovery and rising confidence, reinforced by this month's election result. But Japan's reviving domestic economy is an exception in a world that remains too dependent on American demand. The combination of slower consumer-spending in America and few alternative sources of demand suggest the world economy will slow. Given that it is growing above its sustainable rate, and badly out of balance, that may be no bad thing. But as with all balancing acts, the risk is that any adjustment, when it comes, goes too far.

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Germany

Germany's nightmare

Sep 22nd 2005
From The Economist print edition

The inconclusive result on September 18th will do Germany no good

Get article background

IT COULD hardly have been worse. Germany, which has Europe's biggest and, until recently, most sluggish economy, badly needs a government with a working majority and a clear commitment to further reform to bolster its incipient recovery. That is why *The Economist* hoped that, when Germany's voters went to the polls on September 18th, they would choose Angela Merkel's centre-right opposition over Gerhard Schröder's centre-left government.

Instead, a divided electorate has given a majority to nobody. All the political parties, and their leaders, are now engaged in tortuous manoeuvring over possible coalitions that smacks more of Weimar than of the Federal Republic (see article). The outcome of these negotiations remains uncertain but, on almost any betting, it will produce a weak, short-lived government that has little capacity for further reform. Not surprisingly, business leaders and financial markets are upset: both the euro and the stockmarket have fallen sharply.

How did things come to this pass? Although the result was so muddy, three clear conclusions can be drawn from the election. The first is that German voters rejected Mr Schröder's coalition government, made up of his Social Democrats (SPD) with Joschka Fischer's Green Party. It is worth stressing this point, because Mr Schröder has been trying to portray the SPD's unexpectedly strong showing as an endorsement for his continuing as chancellor. Certainly, he is personally more popular than Ms Merkel. But Germany has a parliamentary, not a presidential system: it is wrong for the leader of a party that won fewer votes and seats than Ms Merkel's Christian Democrats (CDU) and its Bavarian sister party, the Christian Social Union (CSU), to insist on keeping the top job.

The second conclusion, however, is that voters were not persuaded that a centre-right coalition would be much of an improvement over Mr Schröder's lot. Ms Merkel's party did worse than opinion polls had predicted; its 35.2% was a smaller share of the vote even than in 2002, when the CSU's Edmund Stoiber lost the election to Mr Schröder. Thanks to a largely inept campaign, Ms Merkel saw a lead that had at one time touched 20 percentage points whittled away to less than a point by polling day. Voters did not warm to her personality; many were put off by her choice of Paul Kirchhof, a radical reformer who favours a flat tax, as her potential finance minister (he has now quit); others disliked the fact that she was a woman and an easterner.

Above all, though, the third conclusion is that German voters are at best divided over, and at worst hostile to, further reform. Although the SPD did better than most pundits had expected, its 34.3% of the vote was its lowest since 1990. Many SPD supporters went elsewhere or abstained because they hated the limited reforms made by Mr Schröder. This also explains the rise of the Left Party, which took 8.7%, a mixture of mostly ex-communists in the east and others from the left of the SPD following the defection of Oskar Lafontaine, who had been Mr Schröder's first finance minister. It is true that the best-performing party of all was the liberal Free Democrats (FDP). They won 9.8%, and they want more reforms even than Ms Merkel—but some of their extra support came from CDU supporters voting tactically in hopes of fending off a “grand coalition” of the CDU and the SPD.

These voters may be disappointed, for a grand coalition looks to be the likeliest outcome of the parties' manoeuvring in Berlin. And, although Mr Schröder has said he will join such a coalition only if he leads it, Ms Merkel is still the most likely chancellor—unless one of the CDU's regional heavyweights, such as Hesse's Roland Koch, steps in. Moreover, if it included sensible leaders, such as Peer Steinbrück, a former SPD premier of North Rhine-Westphalia, a grand coalition could do a few useful things, notably plugging the gaping holes in Germany's public finances and reforming its federal system.

Yet it seems more likely that a grand coalition, especially one led by a weakened Ms Merkel, would prove both short-lived and ineffective, with the two parties scampering to blame each other for unpopular measures and positioning themselves to exploit another early election. Worse, such a coalition might serve to boost extremists on both left and right. The experience of the only previous grand coalition at federal level, in 1966-69, bears out such fears, though some similar coalitions have worked at state level.

The Jamaica option

There are, unfortunately, few alternatives to a grand coalition. All other parties have refused to negotiate with the Left Party, and they should be held to those pledges. A “traffic-light” coalition of the SPD, Greens and FDP has been unequivocally ruled out by the FDP leader, Guido Westerwelle, who is committed to working with the CDU/CSU. A minority government from either centre-left or centre-right is unlikely to work. That leaves only one other option, short of a new election: a coalition of the CDU/CSU, the FDP and the Greens, known for its black, yellow and green colours as the “Jamaica” coalition.

Mr Fischer has spoken out against such a coalition. But he has also said he is giving up the party leadership, and other Greens are more interested. Even though they are at odds with many of the centre-right's policies, the Greens are at least willing to pursue economic, tax and labour-market reforms, and they carry none of the SPD's trade-union baggage. Unlike Ms Merkel, they favour Turkey's membership of the European Union. Given the rise in recent years of smaller parties in Germany, it will surely be necessary to try out unusual coalitions one day. However unlikely it seems, the Jamaica could be the least bad one to go for this time.

Yet whatever coalition, if any, emerges from the mess, it is not likely to prove either strong or stable. Germans are thus likely to find themselves returning to the polls soon, certainly long before the election due in four years' time. But however many times they are asked to vote, if their economy is to thrive, their country has no alternative to further reform. What a pity that Ms Merkel and her colleagues did not manage to persuade enough voters of that this time round.

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Afghanistan's parliamentary elections

Putting steel into Karzai

Sep 22nd 2005
From The Economist print edition

A relatively peaceful vote, but Afghanistan's future is still not secure

AFP

Get article background

ONCE again, Afghanistan has confounded the doom-mongers. The parliamentary and provincial elections held on September 18th were violent, with 19 polling stations attacked by Taliban insurgents and a dozen people killed. Intimidation and fraud were evident, compounded by a confusing voting system, whereby each candidate stood as an independent. But this was much less chaos than had been predicted; local elections in Pakistan last month were bloodier. And if turnout was down on Afghanistan's uplifting presidential vote last year, at around 50%, it nonetheless bespoke strong support for democracy and for accountable governance. As a milestone on Afghanistan's post-conflict journey, this should be celebrated, but cautiously—for the promised recovery lies further ahead than ruination lies behind.

To the long list of Afghanistan's dysfunctional institutions may soon be added its parliament. By preventing its being organised around political parties, President Hamid Karzai sought to ensure a weak opposition to his strong executive. At first squint, this might look wise: preaching national unity, Mr Karzai has done heroic service. Yet it makes Afghanistan too reliant on one good man, who risks assassination daily, and whose weak strategic vision the ploy typifies. In future elections, the chance of a single seat in an ineffectual parliament will surely fail to persuade warlords to give up their guns.

In this election, as another example of Mr Karzai's weakness, few were obliged to give them up: of 207 “commander-candidates” identified before the poll, merely 32 were disqualified. This was woeful, it disgusted many Afghans, and Mr Karzai is to blame. Before the vote, he received assurances from the two foreign armies in Afghanistan—an American-led coalition fighting the Taliban, and a NATO-led peacekeeping force—that hell-raising from disqualified candidates would

be robustly dealt with. He must now undo the harm his weakness has done, and ensure that no elected candidate, or other official, maintains a militia.

To persuade Mr Karzai to do this, his allies must add steel to their assurances. Even as America pledged to secure the poll, it plotted to withdraw several thousand troops next year. Amid the usual squawking from Germany and France over the ideal role for NATO troops, it was uncertain whether America's European allies would fill the breach as it would like. They must do so. There is more at stake than bolder leadership from Mr Karzai. There are the fights against the Taliban and al-Qaeda and against the Afghan drug dealers who supply 90% of the world's opium. And there is the future of multilateral state-building and, it could be argued, of NATO itself.

Ultimately, however, no western power can end the insurgency raging in southern and eastern Afghanistan, where over 1,000 people have been killed this year, including 77 Americans. That will take years, by bringing greater prosperity to these desolate regions, after first instituting badly-needed economic reforms at the centre. But an eastern power, Pakistan, could reduce the killing. Money sent from Pakistan, as well as sanctuary there for the Taliban leadership, underlies the insurgency's vigour. Pakistan's claim to be unable to police its rugged border no longer rings true: a good portion, adjoining its tribal areas, is now mostly controlled. So should the rest be, and Pakistan must arrest its old friends, the Taliban leaders. Failing this, it will seem more than hapless in the ongoing violence. It will seem complicit.

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Economist.com OPINION

Iran, North Korea and the bomb

Getting beyond no

Sep 22nd 2005
From The Economist print edition

If Iran is allowed to fob off nuclear inspectors, so will North Korea

AP

Get article background

GOOD news is dispiritingly rare in the global effort to curb the spread of nuclear weapons. North Korea seemed to surprise itself this week by agreeing to a set of principles with America, South Korea, Japan, China and Russia to give up its weapons and end its nuclear dabbling—so much so, that a day later it was already bad-temperedly backtracking (see article). Meanwhile, Iran's new government is defiantly refusing to re-suspend uranium work that it has started up again and that brought talks with Britain, France and Germany to a halt. It also threatens to enrich the uranium (just for reactor fuel, it says, though others suspect for bomb-making) and to end all co-operation with international inspectors if the 35-nation board of the International Atomic Energy Agency (IAEA), meeting this week, has the temerity to report its past nuclear rule-breaking to the UN Security Council.

North Korea flounced out of the Nuclear Non-Proliferation Treaty (NPT) in 2003 and claims loudly to have the bomb; Iran, still officially in, claims not to want or need one. So why are the Europeans and America, along with Australia, Canada, Japan and others, pressing to put Iran in the dock at the UN?

The answers can be found in a cascade of IAEA inspectors' reports describing two decades of cheating: covering up experiments to enrich uranium and make plutonium, and lying repeatedly about how much nuclear equipment and materials was bought from the same black-market middlemen that sold Libya a flat-pack bomb-making kit, and that helped supply North Korea too. Just coincidence, shrugs Iran. Yet there are other indications—including possible design work on a nuclear warhead—that its intentions are far from peaceful.

The European three had been trying to talk Iran into giving up its uranium and plutonium

technologies, as the only way to be sure it was not abusing them. Now those efforts have failed, others on the IAEA board, including Russia, China, South Africa and Brazil, are reluctant to press Iran harder. Some fret at measures to curb its “right” to such technologies under the NPT. Others fear (Iraq in mind) that involving the Security Council would mean military conflict; still others that the council would merely do nothing (China did not let it utter a peep over North Korea, preferring those six-party talks).

In fact, the NPT accords Iran only a right to the “benefits of civilian nuclear power”, and only then if it is keeping its non-nuclear promises. It could anyway use nuclear power, as others do, without having dangerous fuel-making technologies. Meanwhile, letting its defiance stand carries big risks.

The IAEA's board has a legal obligation to report safeguards breaches to the Security Council. Ducking it undermines the inspectors' authority. Had Iran co-operated fully with them over the past three years, a report to the council could have been of past breaches since corrected. But Iran chose differently. Russia and others claim they also want to get Iran to honour all the rules. But how best to do it?

For the message to be understood

Iran claims to be in good standing with the NPT. A decision at the IAEA to find it formally in non-compliance with its obligations would usefully set the record straight. Until Iran is back in compliance, others should be called on to suspend nuclear co-operation with it (Russia has been dragging its feet over supplying fuel for Iran's one soon-to-be-operating reactor at Bushehr, but the IAEA is still providing technical assistance and others are involved too). Since Iran has ignored repeated IAEA requests to co-operate fully with inspectors, the UN Security Council could oblige it to do so. If Iran still digs its heels in, the council could suspend the work of other UN agencies in Iran, and its right to vote in the UN General Assembly.

Harsher measures may eventually be called for, but if diplomacy is to change Iran's nuclear mind, it first needs to know that defiance offends not just Europe or America, but the rest of the world too. For if Iran is left to run rings round inspectors, what chance that North Korea will pay them heed?

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Economist.com OPINION

Race

One man's ghetto

Sep 22nd 2005
From The Economist print edition

Britain should worry less about racial segregation and more about poverty

ANY lingering complacency about race relations in Britain was blown away this week—or so it was hoped. Trevor Phillips, chairman of the Commission for Racial Equality, the nation's race watchdog, warned that Britain is “sleepwalking” into a ghettoised society, with “black holes” emerging in some cities. Mr Phillips cited the drowned city of New Orleans, with its suffering black underclass, as a warning about what may happen to Britain if something is not done to ensure more racial mixing. Against fierce competition, it was perhaps the silliest lesson yet drawn from America's tragedy.

Britons are fearful of ghettos these days, though they worry more about south-east Asian Muslims than about blacks. Concern for the poor and downtrodden is one reason; the other is the spectre of alienated, angry young men stewing in their enclaves. Race-tinged riots in 2001 and bombings in London on July 7th this year seemed to underline that danger, which may explain why Mr Phillips's words were welcomed both by Labour and by the opposition Conservatives. The government said this week that it would set up a Commission on Integration and Cohesion, charged with doing something about those who “choose to live segregated lives.” Mr Phillips has a suggestion: gerrymandered catchment areas that would lead to integrated schools—and, eventually, universities.

Before the nation sleepwalks into that kind of social engineering, though, it should look more closely at its own cities. Outside Northern Ireland, Britain has nothing to match America's ghettos, nor is it becoming more ghettoised. The reverse is true. The commonly used index of segregation, which measures the number of people who would have to move in order to spread themselves evenly over a city, shows that every large ethnic minority group became less segregated between 1991 and 2001. The oldest-established group (Afro-Caribbeans) are the most integrated, suggesting that the process has been going on for some time. Far from cowering in their inner-city enclaves, black and Asian Britons are racing to the suburbs. Workplaces are mixing even more rapidly.

It is true that some ghettos are growing even as people flee them, but the cause of that is unsurprising: mass immigration. In any case, does it really matter if neighbourhoods turn one colour? Indians, who are Britain's largest ethnic minority group, are more segregated than Afro-Caribbeans—and much more successful. Britain's Jews are remarkably isolated (52% live in north London), considering how long they have been around, but nobody worries about them.

That, of course, is because they are solidly middle class. Which ought to be a lesson to the race warriors. The real problem is not concentrations of Muslims or non-whites, but of bad schools that impede progress and rampant criminality that means people are periodically relieved of whatever they have been able to amass. Solving these difficult problems, which also affect many whites, would be more helpful than banging on about how Britain's cities are turning into foreign lands. That sort of talk should be left to the extreme right.

Tackling concentrations of poverty is the ideal solution, but increasing overall wealth would help break up ghettos, too. One reason London is less segregated than it used to be, and less segregated than many other British cities, is simply that it is so expensive. For ghettos to form, whites must choose to live apart from non-whites. In a city of astronomical property prices, the lure of cheap housing tends to trump that desire.

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Letters

Sep 22nd 2005
From The Economist print edition

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Fury unleashed by Katrina

SIR – Your fallacious accusation that after Hurricane Katrina America abandoned the dispossessed and didn't bring succour to her people at their greatest time of need would be funny if it wasn't such a sad misconception so far from the truth ("The shaming of America", September 10th). The sick were evacuated, and everyone who was able and willing to leave the region before and after the storm struck did so and is still alive. Rebuilding the lives of over a million displaced people is under way. The mayor of New Orleans intended the Superdome and convention centre to be only very temporary places of shelter and told people to bring blankets, food, water and medicine for up to four days. Those that didn't paid a high price for not following orders.

Moreover, the federal government was prepared long before the storm hit, but had to wait for it to abate and for an invitation from the vacillating governor of Louisiana. George Bush deserves no criticism whatsoever—if he took over the relief effort he would have been chastised, but because he didn't he was still chastised. He was anything but listless or confused. America deserves no shame but rather praise for the heroics of so many selfless people who, given Katrina's vagaries, performed above and beyond the call of duty.

Bob Guertin
Greensboro, North Carolina

SIR – I don't expect the government to bring succour to its people. I would stockpile my own food and water, and lots of ammunition. Shame on *The Economist* for grovelling at the sphincter of politically correct left-wing shibboleths.

Fred Birnbaum
Boise, Idaho

SIR – The shaming of America's government would have been a more appropriate title. American citizens have little to be ashamed of in the aftermath of Hurricane Katrina. Time and private resources have been volunteered while homes and hearts have been opened to the dispossessed. Truckloads of food, water and essentials for daily life were sent to New Orleans from American corporations and non-profit organisations. These much-needed supplies arrived before assistance from any government entity.

Many Americans are ashamed of their federal, state and local governments for the pathetically delayed response and poor preparation. Many of us are also ashamed of *The Economist* and offended by your headline.

Megan L.P. Thomas

Chico, California

SIR – Your cover title, “The shaming of America”, is nothing more than your mission statement as a magazine.

Joel Solliday
Otsego, Minnesota

SIR – The responsibility for mobilising the response to a disaster does not lie “squarely with the federal government”. By law it lies with local and state governments. A governor's emergency operations staff supervises the local and state efforts. This is how the process worked during several hurricanes in Florida last year. Federal responsibility is to provide the vital support requested by local authorities.

Douglas Case
Clearwater, Florida

SIR – Your eye-catching title perhaps would have been more relevant two years ago as “The shaming of France”. Thousands of elderly citizens died during the heatwave that summer, with small mention in your pages.

David Bour
Cupertino, California

SIR – Your report on Katrina's aftermath contrasts the *Wall Street Journal*'s warnings of big-government ineptitude with economist James Galbraith's assertion that America's federal government cannot function properly unless it is “big, demanding, ambitious and expensive”. That is precisely the problem. By any measure, America's government is already all of those things. Its size, demands, ambitions, and expense are causes of, rather than cures for, incompetence. Billions of dollars have been spent on disaster planning, levees and federal housing projects. In every aspect the feds fought nature, and nature won.

Which model would James Galbraith prefer: an inept government at low cost, or an inept government at enormous cost? In theory, that is his only choice. In practice, the first option is unavailable.

Frank McCormick
Eastsound, Washington

SIR – Most of Katrina's victims did not “make the decision” to live in New Orleans. They were born and raised there. Or moved there for jobs that simply do not exist elsewhere. By your logic, the victims of the terrorist attacks in New York and London are partially to blame for their deaths, having “made the decision” to live and work in cities known to be terrorist targets.

David Muhlenfeld
Richmond, Virginia

SIR – The lack of evacuation buses were not the result of racism and class discrimination. It is inappropriate to make race and class an issue when Hurricane Katrina affected most acutely the poor of a city where nearly 63% of the population is black. Instead of shaming us, your usual fair, balanced, and non-judgmental opinion would have been preferred.

John Walker

Scottsdale, Arizona

SIR – For years *The Economist* has taken every piece of socio-economic good news coming out of the US—falling unemployment, rapid economic growth, etc—as a reason to extol the virtues of the American model. But what when the news from the world superpower is bad? Your newspaper's critique of US government institutions is tightly circumscribed: the cronyism of the Bush administration, a lack of co-ordination between state and federal government, and unexplained errors in public spending priorities. But the callous indifference of the public authorities to the fate of the weak and unprotected and the woeful response to the disaster are manifestations of the same system whose praises you so regularly sing.

The European social model may have its deficits, but it is inconceivable that an EU member state would abandon the bottom third of its population either to natural disasters or to the vagaries of untrammelled market forces.

Andrew Watt
Brussels

SIR – President Bush promoted John Roberts to chief justice only 36 hours after the death of William Rehnquist and in the midst of a great domestic humanitarian crisis. If his administration had perhaps treated Katrina with the same sense of urgency, much of the devastation could have been averted.

Bret Kadison
Chicago

SIR – New Orleans's mayor should have called the hawks in Washington before Katrina struck and told them that 30 al-Qaeda-looking types were at the levees. Help would then surely have arrived in time.

Stein Glorvigen
Skjetten, Norway

SIR – We in America now have an idea about where George Bush's "compassionate conservatism" leads. That those in charge may limp with wounded pride into the annals of history is hardly a comforting thought to those drowned, diseased, and displaced in New Orleans out of neglect and sheer apathy.

Murali Reddy
Corvallis, Oregon

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Economist.com SPECIAL

Palestinians in Gaza

Will they sink or swim?

Sep 22nd 2005 | GAZA CITY
From The Economist print edition

Getty Images

Israel's withdrawal has left Gaza seething, lawless, poor, cut off from the outside world—and with a one-time chance to make a new start

NO MORE nervously scanning the concrete watchtowers as you drive near an Israeli settlement. No more being shot at for straying too close to an army post or standing on your own roof. No more gazing through high wire-mesh fences at the forbidden beach just a few dozen yards away. No more impotently staring at the cars bursting with settler children as they drive right past your nose to that very same beach. No more driving the roundabout coastal route because the main road is in no-man's-land. No more waking to the roar of bulldozers flattening your orange grove. No more aching shame at working for the settlers because there is nothing else. No more waiting for unexplained hours in the baking sun or through the night at the Abu Holi checkpoint, the only gateway between north and south.

Freedom! After the last Israeli soldier departed on September 12th and the border to Egypt lay temporarily open, it was as if the entire Gaza strip released a breath it had held for 38 years—expelling thousands of residents for a few frenzied days of shopping and visiting in the northern Sinai, then sucking them back in again laden with goods and livestock, and some with guns and drugs. The strip's southerly beaches, once the exclusive preserve of the settlers, were flooded with families, some of whom had lived for decades a stone's throw from them. The orgy of looting and burning in what remained of the settlements was, like the rush across the border, ignored by the Palestinian Authority, and even Israel's government protested only half-heartedly. Both understood that a people trapped for decades needs a respite of at least a few days.

But as Egypt began reluctantly closing the border that it now controls, claustrophobia returned. The Israeli army, redeployed outside the strip, has upgraded its technology to prevent anyone getting through the fence and is building a second line of defences around it. Its white surveillance

balloons and buzzing pilotless drones will continue to remind Gazans that they are being watched. Israeli officials promise an even harsher response than before to rocket attacks from Gaza. Movement in and out of the strip will become ever more precious a privilege, as Israel gradually meets its target of having no Palestinian workers at all on Israeli soil by the start of 2008.

Inmates of the Soviet Gulag used to call their prison camp “the zone” and the Soviet Union, wryly, “the Big Zone”. Gazans talk in similar terms about their home; and it is not that big either, with some 1.4m inhabitants in an area a little over twice the size of Washington, DC. Over 60% of them live in the refugee camps that have developed into seamless extensions of its ramshackle cities. The geography—45km (28 miles) long, 2-5km wide and nowhere more than 105 metres high—is about as dull as it gets. More than twice as much water is pumped out of the aquifer as goes back in, so that what comes out is something even prisoners would refuse to drink. The only territories that beat Gaza in population density are Macau, Monaco, Hong Kong, Singapore and Gibraltar, and its population will double by 2020. In GDP per head, though, its near-equals are a rather less flashy bunch: Malawi, Burundi, Somalia and Sierra Leone.

Yet optimists argue that Gaza could one day be mentioned in the first list of places rather than the second: small, dense, semi-autonomous, poor in natural resources, but thriving. The “armpit of Palestine” it may be, but armpits are also pivotal places. In ancient times it was a key port on the incense-trading routes from the Mediterranean to the Red Sea and thence to India and China; later, it was one of the lesser attractions on the Christian pilgrimage tour. Hidden among its never-quite-finished concrete buildings are old mosques and churches, ancient mosaics and other fragments of civilisations gone by.

It has always done well in agriculture, whether locally grown crops or, more recently, the profitable export delicacies raised by Israeli settlers in their greenhouses. The endless beach, cleaned up a little, could attract tourists from all around the region. Gaza is next to, and knows how to work with, the Middle East's most advanced economy: Israel. Its people, having spent decades striving to give themselves the best chance of getting out, are highly educated compared with those in most Arab countries, and skilled as well: wandering in the diaspora, Palestinian labourers and engineers built much of the Middle East and, as they ruefully acknowledge, much of Israel too.

Finally, Gaza could be awash with money if it wanted. Foreign donors are lining up to pay for infrastructure and economic-development projects, or to restart those that were put on hold during the second *intifada*, which began in 2000. Prosperous Palestinian exiles are a huge reservoir of potential investment. The Palestinian Authority (PA) has revised its land-use plan to envisage keeping the former settlement areas for agriculture and tourism, building new housing districts east of the current main cities, expanding the border industrial zones, building a seaport and restoring the shattered airport, and building a coastal highway and even a light railway.

But for the grand schemes to have even a chance, Gaza needs two things guaranteed: access to the outside world and internal stability. The first depends mainly on Israel; the second mostly on the Palestinians; but they are intertwined. And both are looking extremely shaky.

Escape from the mini-market

“If I were an investor and businessman looking at this, I wouldn't touch it. It's too risky.” Snappily dressed Bassil Jabir is talking about his main project: the takeover of some 400 hectares of greenhouses, which American Jewish donors paid the settlers $14m to leave behind. Mr Jabir heads the Palestinian Economic Development (PED) Company, set up by the PA to run the greenhouses and keep their 3,000-4,000 labourers in work until buyers are found. Later, PED plans to become a sort of equity fund for local start-ups; it hopes to have $1 billion invested within five years.

But the greenhouses are an iffy proposition. Partly because nobody knew what condition they would be in until they were handed over (answer: mostly passable, though the settlers had ripped out some of the equipment and plastic sheeting, and Palestinian looters ripped out more). Partly because of the problem of water. But mainly because nobody knows whether their crops will get to market. The strawberries, carnations, cherry tomatoes and other high-profit produce that made Gush Katif one of Israel's agricultural export powerhouses will find few buyers in Gaza; the more mundane crops could compete with local farmers and send prices plummeting. Whether the goods get out of Gaza depends on what happens at the borders.

At the moment Israel, for security reasons, unloads and inspects the goods at the border, then loads them on an Israeli truck—and then unloads and reloads again if the goods are destined for the West Bank. Since the *intifada* began, waiting times at the borders, and with them transport costs, have shot up. “It used to cost 1,000-1,500 shekels ($220-330) to bring a truckload from the West Bank to Gaza,” says Salah Abdel Shafi, an economic consultant in Gaza. “Now it costs 7,000.” Even a short delay can ruin perishable goods for the demanding export market.

The Palestinians want to replace this “back-to-back” haulage system with a “door-to-door” one. Foreign donors have agreed to pay for huge scanners that would let soldiers examine a whole truck. But first the two sides must resolve a dispute rooted in history about whether Gaza's northern border should in fact be a kilometre farther north. Then ordering and installing the custom-built scanners will take at least a year. And even then, says an Israeli official, Palestinian drivers are still considered a security risk: “A truck like that, someone can take it and run over anybody he wants to.” One option, he says, might be escorted convoys, which ran between Gaza and the West Bank several times a day before the *intifada*.

But the position, on this and other issues, keeps changing. Israel said yes to letting Gaza rebuild its seaport. But will it insist on monitoring the imports and exports, or allow a third party to do it? Re-opening the Gaza airport, says the Israeli official, “isn't on the agenda right now”. On the Gaza-Egypt border, Israel has closed its terminal at Rafah, insisting that all people and goods must move through the Kerem Shalom tri-border point, within Israel, until a new deal is worked out on the unified customs process. At present everything goes through Israeli customs, which then gives the PA the revenues on imports destined for the Palestinian territories. For Gaza to be truly autonomous, it would have to give up that relationship. But then it would be under a different regime from the West Bank, thus breaking Palestine further apart.

Reuters

Greetings from Hamas

Gaza-West Bank ties also depend on having more or less free access between them. But talks on a sunken road for Palestinians to travel the 35-40km across Israel are stuck too. Meanwhile, Israel is beefing up its system of permanent checkpoints outside each West Bank city, turning each one, in effect, into a mini-enclave and pushing up the costs of movement between them.

All that is bad news not just for strawberries, but also for tourism, manufacturing and just about anything else that Gazans could do to earn money. The Israeli insistence on gradually cutting out Palestinian labour in Israel is a serious blow too. Without much more freedom of movement, argued the World Bank in a report last year, even all the promised donor money will not stop the Gazan economy collapsing even further than it has.

The problem, complain Palestinian officials, is that Israel still treats its withdrawal from Gaza as the unilateral move it originally was. “The challenge is to create a balance between legitimate Israeli security concerns and Palestinian demands for economic recovery,” says Saed Bamya, who leads the Palestinian negotiating team on the border crossings. “But when your counterparts are generals and defence ministry people, their only thought is security. They're not willing to consider risk management, standards, co-ordination, market needs or a normal business environment.”

For the same reason, Israel has not decided what economic relationship it wants with the Palestinians in the long term, says Arie Arnon of the Aix Group, a group of Israeli and Palestinian

experts studying that question. Should the customs union ultimately remain or be dismantled; should Gaza and the West Bank be treated as one entity or two; should there be a lot of Israeli-Palestinian trade, or a little? Unless Israel is willing to think about “the principles of a final-status solution”, says Mr Arnon, today's questions of borders and ports will not be resolved. But Israel's current approach is to leave final-status issues well alone.

Shimon Peres, Israel's vice-prime minister and a loud advocate of helping Gaza develop, this week took over the responsibility for talks from the defence ministry. That might change attitudes a bit. But much time has already been lost. “People need to see quick, tangible results, or the whole thing will collapse,” insists Mr Abdel Shafi. He says that a few low-risk concessions, such as issuing more temporary work permits or keeping the crossing points open longer so more trucks can go through, would generate instant good feeling and buy some time.

However, the general Israeli line, as expressed by Ariel Sharon, the prime minister, in a speech last week at the United Nations, is that “Now it is the Palestinians' turn.” Gaza, he said, will be a proving-ground for the PA, a test of its ability to dismantle the militant factions there and of the Palestinians' worthiness for statehood. Israel's reward for its relatively quick and smooth Gaza withdrawal is that the rest of the world buys his argument.

Guns, jobs and trouble

“Jerusalem and the West Bank after Gaza”, read the bright yellow banners, in English, that hang over Gaza City's main streets. They are signed: “Hamas”. In public relations as in everything else, the Islamist party and the main opposition to the PA's ruling Fatah is streets ahead of its rival. It is popular both for leading the *intifada*—which 84% of Palestinians believe prompted the Gaza disengagement, according to a poll this month by the Palestinian Centre for Policy and Survey Research—and for its extensive social programmes for the needy. It is now winning a third pillar of support with its efficient running of the municipalities that it won in two rounds of elections earlier this year. A third round, plus legislative elections due in January, may well cement it as the biggest political force in Gaza.

Israel says it will do all it can to obstruct the elections if Hamas takes part. But Hamas's militant wing is much too powerful and enjoys too much popular support for the PA to tackle it, and when Mahmoud Abbas, the Palestinian president, calls for it to disarm voluntarily, he is laughed at. Recently it named its regional commanders for Gaza, in a direct challenge to the PA's own forces. Though it has largely observed a general ceasefire called in February, there is a fear that once it has received a mandate in the elections, it will restart the *intifada*, perhaps transferring it to the West Bank. Or it might take the cynical option of launching attacks to provoke an Israeli clampdown and boost its own support.

Yet Hamas has also shown that it can be a force for order. Before and during the Israeli withdrawal it worked closely with the PA and other factions, through a long-standing forum called the Higher Follow-up Committee, to minimise violence, even after two lethal attacks on Palestinians by Israeli extremists. If Hamas does well in the elections, “it will become more accountable than ever,” says Ziad Abu Amr, a legislator and member of the committee. And polls also show that most Palestinians do not now want another *intifada*. If their lives also improve in the wake of the Gaza disengagement, they might want Hamas to behave with more restraint as an elected part of the PA.

The more unpredictable threat comes from within Fatah itself. Gaza has seen a spate of violent attacks and kidnappings, some by powerful family groups, others by squads of Fatah militants who also work for the security services. Most are meant to put pressure on the PA to release jailed relatives or to protest job cuts. In a way they are even promising signs: that the PA is trying to

impose reform. But they underline its impotence—most dramatically this month, when a large gang assassinated Musa Arafat, a former security chief and cousin of the late Palestinian president. Palestinian officials have estimated that armed groups have twice as many weapons as the PA, and that was before the brief opening of the Egyptian border allowed them to smuggle in thousands more.

Infighting between powerful members of Fatah has also held back reform of the security services. Since Israel's disengagement Gaza has teemed with armed gangs staking out patches, and Mr Abbas stayed away from one of the main celebration rallies out of fears for his own safety. That is hardly an advertisement to come to Gaza and invest.

The noise and dust of politics obscure the fact that in the end, it all comes down to economics. Gazans who cannot get any work will take the 100 or 200 shekels a month that the militant factions offer. Both Israel and the PA can do a lot to create jobs: Israel by making the effort to balance security with openness, and the PA by organising itself to carry out the mass of infrastructure projects that donors are willing to pay for. That could turn the vicious circle of no security and no prosperity into its virtuous opposite.

Indeed, right now Mr Abbas's and Mr Sharon's interests are aligned, argues Gershon Baskin of the Israel/Palestine Centre for Research and Information, a think-tank in Jerusalem. Poverty in Gaza will strengthen the militants at the expense of Mr Abbas and increase the risk of terrorism; that in turn would fortify Mr Sharon's hard-right critics who opposed the disengagement plan. With Israel also facing elections soon, the two leaders have an incentive to support each other. But it may be fleeting, and mistrust may be a stronger force.

There are still some who believe. Five years ago, pious militants burned down Basil Eleiwa's hotel in Gaza City because it allowed guests to bring their own alcohol. But he kept opening businesses; the newest, just two months old, is “Roots”, a swish but firmly booze-free restaurant frequented by top PA officials. As waiters bring fresh carrot juice and Albinoni's “Adagio” plays in the background, it is easy to share his optimism. “Gaza for me is a kind of addiction,” he explains. After 20 years doing business there, he still thinks the place has potential, and now has a chance to prove it. He also thinks it could be the last it gets.

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Medicaid

Swamped

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AP

Hurricane Rita is on the way. But Katrina has already dashed hopes of reforming America's health-care system for the poor

AFTER sleeping on top of her fridge for three days to avoid the floods, Maude Jordan was eventually rescued from New Orleans. She was taken to a relief centre in Baton Rouge where, penniless and diabetic, she was miffed to be served doughnuts for breakfast each day. On the plus side, she assumed she would qualify for free medical treatment under Medicaid, the health programme for the poor.

Her application was rejected, however. She received a letter which said she was “unable to establish eligibility because cannot establish categorical eligibility [sic]”. That may make sense to a Medicaid bureaucrat, but to Ms Jordan it was about as clear as the lake of diluted sewage that had swamped her home.

Among the many things that Hurricane Katrina destroyed was any hope of reforming Medicaid soon. The programme is one of the government's three great budgetary headaches; the others being Social Security (pensions) and Medicare (health care for the elderly). The other two get more attention, but Medicaid, which is funded jointly by the federal government and the states, is arguably in worse shape.

Before Hurricane Katrina (and now the prospect of Hurricane Rita) shook up everyone's calculations, Medicaid was expected to cost $329 billion this year, making it as large as Medicare and the single biggest expense for the states. Even more striking is the rate of growth. Medicaid is

expected to swallow 2.6% of GDP this year, 13 times its share in 1966, its first full year of operation. It has grown partly because medicine keeps getting more expensive, but mostly because it now covers far more people than its founders ever envisaged.

It is no longer just a safety-net for the poor. As private health insurance has grown ever more expensive—the average family policy cost more than $10,000 this year—small firms have stopped offering it. To prevent the number of uninsured Americans from rising, successive governments have relaxed the eligibility criteria for Medicaid. Some 52m people now receive its benefits, a caseload that has soared by 30% in the past five years.

Before Katrina, Republicans in Congress had been planning to cut the programme by $10 billion by 2010 (“cut by $10 billion” being Washington-speak for “increase massively, but by $10 billion less than had previously been planned”). Since the hurricane, however, no politician wants to be seen denying health care to the needy, so plans for even mild austerity have been shelved.

Katrina's direct effects on Medicaid will be severe. By destroying tens of thousands of jobs, it has undoubtedly made more people poor enough to join the programme, at least temporarily. It has also driven hundreds of thousands of poor people into neighbouring states, where many will stay and claim Medicaid benefits. This would probably have bankrupted Texas's Medicaid programme, had the federal government not promised last week to cover the extra costs imposed by the evacuees (costs that may rise again after Rita).

In the long term, Katrina's main impact on Medicaid may be indirect: it seems to have ruined everyone's appetite for serious reform. This is a shame, for the programme has big flaws. Though it provides an essential safety net for the poor and disabled, it does so with spectacular inefficiency because “too many people are allowed in and too many are gaming the system,” says Robert Helms of the American Enterprise Institute, a think-tank.

You don't have to be poor to qualify for Medicaid. In some circumstances, a family of four can earn $40,000 a year and still get state-funded health insurance for the kids. And although 75% of Medicaid's beneficiaries are poor children and their families, some 70% of Medicaid spending goes on the elderly and the disabled, who cost several times as much to look after.

The elderly have their own health-care programme, Medicare, but it has big gaps in its coverage. Medicaid fills these gaps: for example, it pays for almost half the nursing-home care in America. In theory, Medicaid pays nursing-home bills only for old people who cannot pay their own. But with a shrewd lawyer, even the well-off can reshuffle their assets until they qualify.

No politician wants to be seen denying health care to the needy, so plans for even mild austerity have been shelved

For low-paid workers, Medicaid's very generosity creates perverse incentives. If they earn too much, they can lose their benefits. Since these average more than $6,000 per beneficiary, a pay rise can make a single mother simultaneously much worse off and more worried about her children's health. In some states, Medicaid recipients are similarly discouraged from saving or accumulating assets, such as a car that might get them to work. This keeps many trapped in poverty they might otherwise have escaped.

Medicaid programmes are run by the states, but the federal government pays most of the costs. For every dollar a state spends on Medicaid, Washington, DC, has to contribute on average $1.30 (the rate varies between rich and poor states). This gives states an incentive to spend more on health care than on other equally desirable goals.

Medicaid's expansion, in turn, tends to “crowd out” the cheaper types of private health insurance.

No private insurer can offer its services free, which is mostly how Medicaid appears to its recipients. Small firms are stopping providing health insurance partly because they know the taxpayer will pick up the slack.

Some attempts have been made to restrain spending. In the past three years, all 50 states have tried to squeeze the prices they pay for drugs and doctors. In addition, 38 have tried to tighten the criteria for eligibility and 34 have reduced the range of benefits. Tennessee has made the most controversial efforts, with Governor Phil Bredesen seeking to remove 323,000 beneficiaries from his state's Medicaid rolls.

The perils of reform

But Medicaid is popular, so most politicians try not to cut it much. The only brutal cost-curbing measure applied nationwide is impenetrable bureaucracy, of the sort that so flummoxed Ms Jordan, though this was probably not designed as a cost-curbing measure.

Medicaid's defenders point out that without it, “the vast majority of its beneficiaries would join the ranks of the 45m uninsured Americans,” as the Kaiser Commission on Medicaid and the Uninsured puts it. And though it may be inefficient, it is no more so than the other parts of America's higgledy-piggledy health-care system. Medicaid costs are increasing more slowly than those of private health insurance, despite the fact that private insurers often exclude those with expensive chronic conditions, whereas Medicaid embraces them.

So no one is suggesting axing Medicaid. But some say it could be reshaped as thoroughly as welfare was in the 1990s. Michael Cannon of the Cato Institute, a libertarian think-tank, recommends targeting benefits to the truly needy (by, for example, getting prosperous elderly folk to pay their own nursing-home bills), eliminating perverse incentives and promoting more competition between medical providers. He reckons that such tough reforms could save $941 billion by 2015, wiping out 96% of the cumulative ten-year federal deficit. Instead of which, Congress is offering golden sticking plasters.

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Katrina and public housing

A voucher for your thoughts

Sep 22nd 2005 | NEW YORK
From The Economist print edition

How should America house its poor?

Reuters

Houses but not homes

IF KATRINA has demolished hopes for reforming Medicaid, it has at least stirred up debate about housing policy. In all, Katrina destroyed or damaged roughly 300,000 homes. According to the National Low Income Housing Coalition (NLIHC), around 70% of these were occupied by low-income households (ie, ones earning less than $40,800 in New Orleans and below $32,560 in Mississippi). Hurricane Rita is expected to cause further carnage.

The administration's immediate answer—to buy up trailer parks to house the newly homeless—looks an unsatisfactory stop-gap. Many of the parks are a long way from any potential source of employment. Horror stories are circulating about “FEMA City” in Florida, where 1,500 people displaced by Hurricane Charley in August 2004 are still living in 500 trailers. They can't afford to live in the new houses rebuilt on the sites of their old homes. So they fester in a crime-ridden ghetto.

As a longer term solution, Mr Bush has proposed his urban homesteading plan. He would distribute federal property to “homesteaders” who pledge to build their own homes. That is surely better than the huge public-housing projects for the poor of the 1960s and 1970s. But the Department of Housing and Urban Development (HUD) has identified only 4,000 potential spots for the quarter of a million displaced people. Also, roughly half the people affected by Katrina were renting their property; many are unlikely to have the wherewithal to be able to build their own place.

An alternative could be rental vouchers. After the 1994 earthquake near Los Angeles, which left 20,000 people homeless, Congress swiftly appropriated $200m to provide special vouchers for use

anywhere in the state. At least 10,000 people used them to move into stable apartments, often in better neighbourhoods than those they had left. There are some 1m vacant rental units in the South. Surely it would be better to use them, not build trailer homes?

Controversial though they are in education, vouchers have been part of federal housing policy since the 1970s. Those in LA were part of the “Section 8” programme, which is actually the main form of federal housing assistance. Some 2.1m vouchers, worth around $7,000 a year each, are in circulation. Republicans like them for ideological reasons; Democrats (who in this case don't have to deal with the teachers' unions) like them because they get money to the poor.

At their best, vouchers help “deconcentrate” poverty. For instance, in the Gautreaux Programme, an experiment to combat racial discrimination in Chicago's public housing in the late 1970s, poor blacks were given vouchers to move to the white suburbs. It seemed to help them. Their children tended to do better in school and go to college, explains James Rosenbaum, a sociology professor at Northwestern University.

That does not mean that vouchers work perfectly. They can create perverse incentives: HUD's vouchers work on the basis that you should spend 30% of your income on rent, but if your rent is pegged at that proportion, there is less incentive to try to get a pay rise. They also encourage poor families to move to public shelters, because residents there are often given priority when it comes to vouchers. As for deconcentrating poverty, elite white neighbourhoods are not always welcoming to poor black families. And some working-class families—though perhaps fewer than middle-class communitarians claim—prefer to live next door to each other.

Yet the main problem with vouchers is simply that there are not enough of them. Only about one in four eligible households gets any kind of assistance, and waiting lists for vouchers can be years long. Last year, Congress rejected the administration's proposal to cut $1.6 billion from the Section 8 programme, which would have cancelled the vouchers for some 250,000 households. This year, the administration is again trying to cut the programme to save money.

Even without Katrina, America would have a shortage of affordable housing. Thanks to the fact that rents have risen much faster than incomes, nearly one in three households spends more than 30% of its income on housing, and one in eight spends more than 50%, according to Harvard's Joint Centre for Housing Studies. To make matters worse, most new housing tends to be at the more expensive end of the market.

A good deal of this can be blamed on America's property bubble; when it bursts, things should even up a bit. But housing is also one of the areas where government handouts (especially tax relief on mortgage payments) favour wealthier Americans. In 2003, $121 billion was spent on tax relief (more than $57 billion of which went to households with incomes above $148,000); by contrast, only $36 billion was spent on housing policies designed to help the poor.

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The Virginia governor's race

A Bush referendum?

Sep 22nd 2005 | RICHMOND
From The Economist print edition

A local race with implications for the White House, current and future

AP

Kilgore on the prowl

RICHMOND is about 900 miles (1,450km) from sodden New Orleans and about 7,500 miles from bloody Baghdad. But the three-way race for the governor's mansion in Virginia, featuring two yuppie lawyers and a plain-talking grandfather, will be one of the first electoral tests of how much damage George Bush has suffered.

At first blush, the Virginia race should be a walkover for the Republican nominee, Jerry Kilgore. Mr Bush easily carried the state in 2004. Conservative issues such as gun rights, abortion restrictions, taxes and gay marriage strongly resonate here. The Republican Party controls the legislature. Mr Bush's political team, well aware that the Virginia race may become a referendum on him, has dispatched nearly two dozen operatives to the state.

However, Mr Kilgore, a slick former attorney-general whose banjo-like twang is the only remaining clue to his mountain roots, is in a statistical tie with the Democratic lieutenant-governor, Timothy Kaine. The Republican appears to be running into headwinds. Virginians, most of whom are car-dependent suburbanites, are angry about $3-per-gallon petrol. They sense that the war in Iraq, which has claimed 54 Virginian casualties, is not going well. Racial tensions, unleashed in New Orleans by the slow federal response to Hurricane Katrina, may be stirring in the state, too.

A year ago, Mr Kilgore would have spent a lot of time trying to lure Mr Bush across the Potomac river to join him on the campaign trail. Now that the president's approval rating in the state is only 42%, according to a recent poll by the *Richmond Times-Dispatch*, Mr Bush's main use is as a partisan fund-raiser. He pulled in $2m for Mr Kilgore at a private dinner in July.

The governor's race could also have ramifications for two people who want to succeed Mr Bush: Virginia's junior Republican senator, George Allen, who would be just as embarrassed as the president if the Democrats were to win in his back yard, and its current Democratic governor, Mark Warner. The race is something of a referendum on Mr Warner, too, who has to step down under term-limit rules. He enjoys an approval rating of close to 70% in the latest survey by the *Washington Post*, and he has just started to campaign all-out for Mr Kaine, who promises to continue his centrist programmes.

The Warner legacy includes the seemingly unspeakable in Virginia: a $1.4 billion tax increase in 2004. But that saved the state's high credit rating on Wall Street and restored millions to schools, the police and various welfare programmes. These had suffered during the recession, the post-September 11th aftershocks (the Pentagon, which was attacked, is in Virginia) and the ever-increasing cost of a Republican-sponsored cut in the motor-vehicle tax that even some Republicans now think was a stupid idea.

Mr Warner is still in trouble with some conservatives for backtracking on his original promise not to raise taxes, but for the most part his fix is depicted as a noble exercise in statecraft. The tax increase, repackaged as “budget reform”, has provided Mr Kaine with a theme. It certainly means the somewhat glib Harvard-educated lawyer has to spend less time justifying his liberal views on capital punishment and gun control to voters.

One problem for the calculations of Messrs Kaine and Kilgore (and, for that matter, for those of Messrs Bush, Allen and Warner too) is the presence on the ballot of an independent state senator, Russell Potts. In February, the blustery sports promoter bolted from the Republicans, angered by their lurch to the right. At first it seemed that he would bleed moderate Republican votes from Mr Kilgore, but now he is targeting Democrats who think Mr Kaine is too meek on issues such as transport and abortion.

Mr Potts clearly fancies himself as a teller of home truths in the Ross Perot mould. He also seems to suffer from the Texan billionaire's petulance and tin ear when it comes to politics. He could well hold the key to the race.

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Guantánamo Bay

Empty beds, empty stomachs

Sep 22nd 2005
From The Economist print edition

Some are going home, others are on hunger strike. All are in legal limbo

EPA

On the march

THE emptying of Guantánamo Bay has begun. From a peak of 660, the number of al-Qaeda and Taliban suspects being held at the American naval base in Cuba has fallen to around 500. A deal with the Afghan government last month should see the repatriation of the remaining 110 Afghans. A similar agreement with Saudi Arabia should see another 100 people sent home. Others still hope that some form of judicial action will free them.

Two years ago, Donald Rumsfeld, the defence secretary, was insisting that most people would be detained at the camp for as long as possible. “Our interest,” he said, “is in *not* trying them or letting them out.” That was before Abu Ghraib and scandals involving allegations of abuse at other American prisons in Iraq and Afghanistan. “Our desire is not to have these people,” Mr Rumsfeld now says. “Our goal is...to have them...in the hands of the countries of origin for the most part.”

Since Guantánamo was opened as a detention camp in January 2002, nearly 250 detainees have been sent back to their home countries. At first, this was because they were deemed no longer to be a threat or of intelligence value. But, increasingly, detainees who are still regarded as a security risk are being transferred into the custody of their home governments.

Under the UN Convention against Torture, America—like Britain, another signatory—is banned from expelling anyone to a country where he could be in danger of torture or other cruel, inhuman or degrading treatment. The Pentagon has insisted on “diplomatic assurances” that the suspects will be treated humanely. To the horror of civil-rights groups, people have already been dispatched to Russia, Egypt and Pakistan (as well as Saudi Arabia and Afghanistan), though around a dozen detainees due for release, including some Yemenis and Chinese Uighurs, are being kept in a special “luxury” wing of the camp.

Earlier this summer, there was talk of Guantánamo being shut down. Patrick Leahy, the senior Democrat on the Senate Judiciary Committee, called it a “national disgrace” and “the primary recruiting tool for our enemies”. George Bush also seemed to wobble on the issue. But Mr Rumsfeld, who has just spent $100m refurbishing the camp, has never wavered from the idea that America needs a place to hold people indefinitely. If you want to create a “legal black hole”, to use the words of a British law lord, it is certainly a lot easier to do so outside the American mainland.

But what about the Supreme Court's ruling in June last year giving Guantánamo detainees the right to challenge their detention in American courts? The justices, alas, did not give any details as to how this could happen. The administration promptly set up review panels to determine whether

detainees had been rightly designated as “enemy combatants”; all but 38 of the 558 detainees had their status confirmed. Banned from attending the proceedings, their lawyers have dismissed them as a sham.

Dozens of *habeas corpus* lawsuits are working their way up through the federal courts. In January this year, a Washington, DC, district court judge ruled that the detainees were entitled to challenge their detention in normal courts. But a few days later, another district court judge issued a contradictory ruling. Both sides have appealed (oral arguments were heard by the DC appeals court this month), but the issue will surely go to the Supreme Court.

Meanwhile, the administration is pressing ahead with its plans to try some detainees before special military commissions. So far, only four have been charged, with a further 11 “designated for trial” by Mr Bush (though an Australian and two Britons have since been sent home). Privately, officials admit that no more than a small percentage of detainees will ever be charged. Even if acquitted, they could continue to be held as “enemy combatants”.

Last November, the first trial of a Guantánamo detainee—Salim Ahmed Hamdan, Osama bin Laden's former chauffeur, who is charged with being a member of al-Qaeda—was stopped after a federal district court ruled that the military commissions did not conform with America's military code of justice or with international law. But in July a three-member panel of the DC appeals court, which included John Roberts, Mr Bush's nominee as chief justice of the Supreme Court, overturned that ruling, saying that the commissions were perfectly lawful. Although Mr Hamdan has petitioned the Supreme Court for a review, his trial before a military commission is expected to resume soon.

Over the past month, more than 100 detainees have been on hunger strike in protest against their indefinite detention without charge. Many have been held for nearly four years. A military spokesman said this week that 85 were still refusing food, including 15 hardliners who were undergoing “involuntary feeding” in hospital. Preventing prisoners from harming themselves was part of “standard operating procedures” in both American civilian and military prisons, he said.

Although not specifically banned under international law, force-feeding of prisoners is prohibited under the World Medical Association's 1975 Declaration of Tokyo, which has been endorsed by the American Medical Association. The International Committee of the Red Cross also strongly advises against it. Its use in Guantánamo is likely to further enflame anti-American sentiment among Muslims; on the other hand, it may be preferable to a succession of deaths in Guantánamo.

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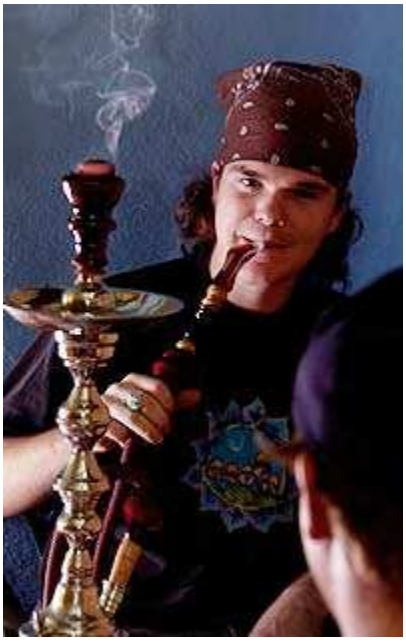
Hookah bars

Smoke like an Egyptian

Sep 22nd 2005 | AUSTIN
From The Economist print edition

Mint, cappuccino or kiwi-strawberry?



Hubble bubble, no toil or trouble

AT THE Hookup Lounge near the University of Texas (UT), 20-somethings loll about, some encased in plumes of smoke. But they are not snogging, yet. In true academic spirit, they are learning the ways of another culture—and passing around a hookah pipe. “I normally smoke cigarettes, but it's kind of nice not having to get up and go outside,” says Jon Faviell, who is trying to get into graduate school at UT. He is sharing a mint pipe with a friend.

Alas for Austinites, there are now fewer hookah places to puff. At the beginning of this month, a city-wide smoking ban went into effect. Smoking indoors in public areas is now mostly restricted to the likes of nursing homes and bingo halls. The Hookup Lounge (named for its, ahem, wireless access) survives because it is classed as a retail tobacco store (the bulk of its sales being derived from tobacco products). But one downtown Austin bar, the Red Fez, no longer offers hookah. Another, One2One, is opening up new patio space to keep patrons puffing; on the night before the ban it sportingly offered free hookahs until midnight.

Hookahs used to be associated with marijuana, opium dens and progressive rock (or that's what we vaguely remember). But legitimate hookah bars started appearing in California in the late 1990s, and, despite the anti-smoking surge, they are booming, especially in college towns.

Brennan Appel of SouthSmoke.com, a hookah-merchandise supplier, reckons that there are now several thousand bars and lounges (nobody in the hookah trade is that great on specific numbers). Jonathan Fair of One2One theorises that Lewis Carroll's “Alice in Wonderland”, in which a shrunken Alice meets a water-pipe-smoking caterpillar, has had something to do with it.

Despite its Middle Eastern pretensions, American hookah is not quite like the Egyptian kind. American pipes often have several hoses—the better to serve a big table—as against a single hose in the Middle East. The products are also sleeker and more modern-looking, with fewer beads. And then there are the flavours: where Egyptians might opt for simple grape or melon, Americans like to mix and match, with flavours like kiwi-strawberry or blueberry-raspberry—or even cappuccino.

Some hooksters claim that the water-pipes are healthier than cigarettes: even though hookah also involves puffing on flavoured tobacco, the water acts as a filter. Moreover, second-hand smoke is limited: one puff quickly dissipates.

Rubbish, say doctors. “There's really little if any filtration being accomplished by passing the tobacco smoke through the water,” says Ron Davis, a trustee of the American Medical Association.

“There's no reason to believe that smoking through water-pipes is any less hazardous than smoking cigarettes.” In fact, he notes, the girth of the water pipes allows smokers to take bigger puffs than on cigarettes. And don't even get him started on drugs.

None of this deters the hookah crowd. And tactics for getting around the smoking bans are evolving. In Manhattan, plenty of places get classified as tobacco bars and so avoid New York's 2003 ban. Joseph Melamed of the Gypsy Café in Westwood, California, has another strategy. He says that California's smoking ban was enacted to protect employees, not patrons (who can choose to boycott the bar). So he has taken advantage of an exemption for owner-operated bars with no employees, and made his employees part-owners. The gods of Egypt must be smiling.

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American socialism

Battling with demons

Sep 22nd 2005 | BLACK ROCK CITY
From The Economist print edition

How our correspondent gave up capitalism in the desert

A DRY lakebed in the remote desert of northern Nevada is not the most inviting campsite in the world. But earlier this month 35,000 people could be found there. They had come for the week-long Burning Man Festival, which has been countering the capitalist culture for nearly two decades.

The Burning Man turned out to be a four-storey tall wooden statue which was burned to the ground on the penultimate night. While waiting for this to happen, “burners” could attend yoga classes, get a chiropractic adjustment, meet psychic healers, eat sushi at midnight, float across the desert in a wheeled pirate ship, or just sit at a bar and have a beer. For some, it was a deeply spiritual gathering; for others, the best party of the year. But, most surprisingly, it was all free.

Normally, behind any hippie event, there are various corporate sorts or hairy entrepreneurs filling their boots with cash. But at Burning Man all buying, selling or advertising was banned. The 3.75-square-mile (six-square-km) site was strictly a commerce-free zone, with two exceptions to prove the rule: first, you had to buy a ticket to get in (which could cost $300 for the whole week and paid for the site, the Portaloos and a few basic amenities); and, second, at the central camp you could buy coffee, tea and ice. Everything else had to be given away. Even bartering is discouraged.

Larry Harvey, co-founder and director of the festival, says this “gift economy” was a natural outgrowth of over-abundance. In the early years of the festival, burners brought more food and supplies than they needed, so giving and sharing was easy. Now burners compete to find niches in which to contribute, from providing a “Mercury Messenger Service” to serving macaroni and cheese at 4.00am.

Bizarrely, this much bigger version of a potluck supper worked—at least for one week. For several days, your correspondent was fed, lubricated, massaged and psychically improved by various people, including a helpful “acknowledgment angel”, with no payment sought. This rule stood even when he was “branded” at the “I'm OK, You're OK Corral”.

Can the gift economy be taken any further? Mr Harvey, whilst generously considering capitalism “a brilliant idea”, has his hopes: he wants to reform the world's economic system in a process that has to start with a “spiritual redefinition of what is value”. But another veteran burner, Michael Morris, a professor of business and psychology at Columbia University in New York, is sceptical. Non-cash exchange, he agrees, can help people to identify with a wider group. But alas, in our day-to-day lives, we prefer the “uncreative and impersonal” cash transaction.

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Lexington

Send in the cronies

Sep 22nd 2005
From The Economist print edition

Big-government conservatism faces its biggest test so far; it could prove fatal

TEN years ago Bill Clinton declared that “The era of big government is over”. Today big government is back with a vengeance—but this time the supersizing is being done not by bleeding-heart liberals but by out-and-proud conservatives.

Ronald Reagan joked that the most terrifying words in the English language were “I'm from the government and I'm here to help.” George Bush, by contrast, claims to be in favour of “focused and effective and energetic government”. This doesn't mean abandoning conservatism, in his view; it means putting government on the side of conservative principles, such as choice and responsibility.

The political landscape is already littered with monuments to big-government conservatism (or “compassionate conservatism”, in his preferred locution). The Department of Education has been expanded. The Department of Homeland Security is a giant new bureaucracy. The 2003 prescription-drug benefit for the elderly is the biggest expansion of entitlements since the 1960s. Now Mr Bush wants to build an even more formidable edifice—a new shining city in the bayous.

His address to the nation from New Orleans on September 15th was nothing if not ambitious. The federal government will spend “whatever it takes” to rebuild New Orleans. Not content with just “one of the largest reconstruction efforts the world has ever seen”, he wants “bold action” to eliminate poverty in the region. And all this money will be spent in conservative ways. Mr Bush

wants to create a Gulf Opportunity Zone with tax breaks and regulatory rollbacks to lure in entrepreneurs. An Urban Homesteading Act will give the city's refugees a chance to build their own homes. He proposed individual job-training accounts and a school-voucher programme.

This is a bold attempt to discover a silver lining in the hurricane's clouds. But has it any chance of success? The problem is that big-government conservatism is already stumbling under the weight of its own contradictions. The grandiose experiment in the Gulf could be enough to flatten it entirely.

The first contradiction is Mr Bush's insistence on governing like a big-government conservative while taxing like a small-government one. Even before the hurricane hit, federal spending had been growing by 7% this year (on the heels of a 30% hike during Mr Bush's first term). Mr Bush has now promised to spend an additional $200 billion of federal money on rebuilding the Gulf, while ruling out tax increases to pay for it. The money can supposedly come from cuts in other government programmes.

Fat chance. In the 1964 campaign Lyndon Johnson leapt on to the roof of his car, seized a bullhorn and bellowed, “We're in favour of a lot of things and we're against mighty few.” The same can be said of the Republican Congress. A few dissidents have suggested cuts, such as delaying the introduction of prescription-drugs benefits or cutting pork from the highway bill. But as far as Tom DeLay, the majority leader, is concerned, “There is simply no fat left to cut from the federal budget.”

The second contradiction is that Mr Bush doesn't seem to be very good at running government. His detached management style—setting broad goals and letting underlings implement them—relies on putting good people in place. But he hasn't done that. The problem is not just limited to “Brownie” and the cronies at the Federal Emergency Management Agency. Mr Bush's nominee to run the Immigration and Customs Enforcement Agency, Julie Myers, has little relevant experience other than being related to General Richard Myers and married to Michael Chertoff's chief of staff. The president also has a disastrous weakness for old bureaucrats, who sound efficient but no longer are (step forward Donald Rumsfeld). And the White House now has a sleaze problem: the administration's top federal procurement official, David Safavian, was arrested on Monday in a corruption probe linked to Mr DeLay's lobbying pal, Jack Abramoff.

Pork-barrel spending and political cronyism are bad by themselves, but they also mean that, when it comes to big-government conservatism, the big-government part of the formula trumps the conservative part. Remember how “private medical accounts” were supposed to discipline federal spending while introducing choice into the prescription-drugs benefit? Thanks to Mr DeLay et al, it became a giant giveaway to the old.

The Big Not-Too-Easy

Many of Mr Bush's ideas for turning New Orleans into a model for conservative urban reconstruction look half-baked. An enterprise zone was tried a decade ago to little effect. Mr Bush's plan to distribute bits of federal land to “homesteaders” could be frustrated by the shortage of land available. Meanwhile, FEMA is considering buying up hundreds of thousands of mobile homes to house refugees. It might have been simpler (and more “conservative”) to give out rental vouchers (see article).

Add to this the scale of the problems in the region. Poor and crime-ridden, New Orleans has been losing people and businesses for years. Louisiana politics is a byword for corruption (several senior officials in the state's emergency planning agency are awaiting trial for misappropriating funds). And the relationship between federal and local officials is abysmal: witness the president's spat

this week with Ray Nagin, the mayor of New Orleans, over whether people should have been allowed back into the city just as Hurricane Rita was coming.

David Brooks, a *New York Times* columnist, has argued that New Orleans could turn into a latter-day version of FDR's Tennessee Valley Authority—a local experiment that provided a model for national reform. It is much more likely that it will end up as a latter-day version of LBJ's community-action programme—a failed experiment that came to symbolise everything that was wrong with the Great Society.

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The Caribbean

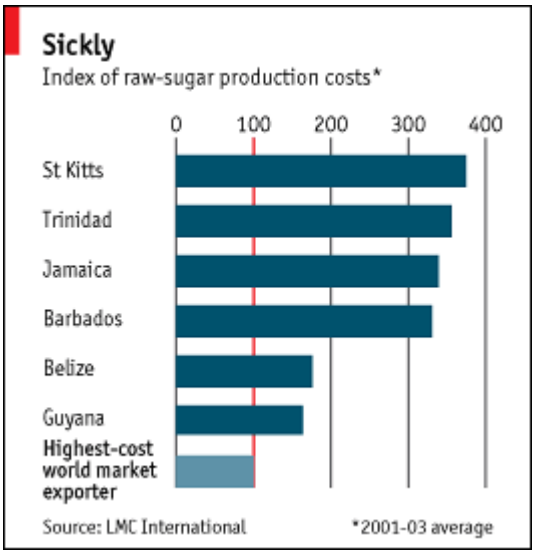
Living and dying on history and artificial economic sweeteners

Sep 22nd 2005 | PORT OF SPAIN
From The Economist print edition

A future without sugar subsidies is one both the Caribbean and Mexico (see article) find hard to contemplate

FOR three centuries after 1650, the English-speaking Caribbean lived from sugar. But for the past few decades this source of sweetness and slavery has been in decline, kept alive by trade preferences. Now the drip feed of subsidy is about to diminish. With bananas, another mainstay, also under threat from changing trade rules, Caribbean political leaders are caught between crying injustice and a long overdue search for alternatives.

The underlying problem is that growing sugar or bananas on small, hilly farms on Caribbean islands is far less efficient than in large, mechanised plantations in Latin America and elsewhere (see chart). Until now, the European Union has bought most of the Caribbean's sugar—at two to three times the world price.



Under a long-standing scheme, 18 former British and French colonies in Africa, the Caribbean and Pacific (dubbed ACP countries) export a fixed quota of sugar to the EU each year at the same price per tonne as Europe pays its own sugar growers. The EU sugar regime was ruled unfair by the World Trade Organisation at the request of Brazil and Australia, the world's most efficient sugar growers. The European Commission has proposed a phased reduction of 39% in its sugar price by 2009, which would still leave it at more than 50% above today's

world-market price.

Europe's farm ministers are expected to make a final decision in November. The details may change, but a big price cut looks certain. So does a row about aid. To compensate for the price cuts, Europe has offered aid of €40m ($49m) next year for the ACP countries. Not nearly enough, complain the sugar growers. Jamaica's trade minister wants compensation of $200m a year for his island alone.

Some Caribbean countries are well-prepared. St Lucia and Antigua stopped growing cane a generation ago. After years of dithering, St Kitts shut its state-owned sugar industry in July. Its annual losses had reached 3% of GDP. The island's former sugar railway now carries tourists. Golf courses and hotels are the most promising alternative crop. The shutdown was cushioned by redundancy payments, retraining and a buoyant labour market.

Trinidad, Jamaica and Barbados still make sugar, but lose money even at today's EU prices. Trinidad closed its state-owned sugar company two years ago; it offered land, retraining and pay-offs to its staff. Some farmers still grow sugar, but may not for much longer. Thanks to natural gas, Trinidad's economy is booming and unemployment is low. In Barbados, sugar employs less than 5% of workers, but keeps the rural landscape trim. In future, it will cost more to keep the cane fields tended for the tourists' cameras.

The biggest challenge is in Jamaica and Guyana. In Jamaica, two privately owned producers make a profit and may survive. The cash-strapped government cannot afford bigger subsidies for five state-owned and loss-making estates. But neither will it find it easy to help several thousand rural labourers gain alternative jobs.

In Guyana, the poorest nation in the English-speaking Caribbean, sugar is the backbone of the economy. Cane fields stretch for miles along the coast. Guysuco, the state sugar company, is in the midst of a $168m expansion and modernisation plan, which involves mechanisation and a new sugar factory. On paper, Guyana's sugar could still be profitable even with a lower EU price. But the margins will be tight, and the industry vulnerable to a weaker euro or natural disasters.

The sugar reform coincides with a new twist in a long-running wrangle over bananas, where ACP suppliers face competition from lower-cost Latin American producers. In 2001, at the urging of the World Trade Organisation, the EU agreed that from January 2006 it would impose tariffs, rather than quotas, on Latin American bananas. The European Commission recently proposed a tariff of €187 per tonne, but Latin American producers have rejected this. A final round of arbitration is likely to result in a lower tariff.

Until the early 1990s, when the EU began dismantling trade protection, family-run banana farms were the backbone of the economy in St Lucia, St Vincent and Dominica. Banana exports from the three islands have fallen by some 75% since then; Dominica, in particular, has suffered a gruelling decade of recession and wage cuts.

Caribbean politicians rail against freer trade, but are loathe to make sacrifices to aid their own. Guyana and Suriname complain that their partners in the Caribbean Common Market (Caricom) cheat them of rice sales by importing subsidised American rice without levying an agreed 25% tariff. Several Caricom countries agreed last month to switch from Trinidad to Venezuela as their main source of oil, in return for subsidies. The Trinidad and Tobago Manufacturers' Association wants to import sugar free of Caricom's 40% duty, rather than give Guysuco a protected market.

Four decades after independence, it is hardly surprising that colonial trade patterns are under threat. Caribbean economies do have a future, but a very different one, as service centres. As well as tourism and offshore finance, both of which could expand further, there are plenty of niches. A

recent World Bank report noted that almost 70% of overseas medical graduates registered in the United States were trained in the Caribbean's 23 offshore medical schools. Some countries need help to make the switch from sugar and bananas. But the future need not be sour—provided that the Caribbean's politicians look to embrace it, rather than cling to the past.

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Sugar in Mexico

How sweet it isn't

Sep 22nd 2005 | MEXICO CITY
From The Economist print edition

Addicted to outmoded regulation

Get article background

MORE often than not in Mexico, a discussion of politics turns into a discussion of history. So diagnosing the ills of the sugar industry, whose costs are three times higher than in Brazil, starts with the Mexican revolution of 1910-17. This began a process of land redistribution which means that the average sugar-cane farm is only about 4 hectares (10 acres). Add poor roads, and outdated railways and sugar mills, and that is why Mexico's sugar industry is so inefficient, argues Carlos Blackaller, a congressional deputy for the Institutional Revolutionary Party, which ruled Mexico until 2000.

Mr Blackaller is also the head of one of two unions of sugar-cane growers. According to Juan Cortina of Grupo Azucarero México, a private sugar firm, it is Mr Blackaller and his union who are the main reason sugar prices are so high.

Because plots are small and unmechanised, some 440,000 work in the sugar harvest, according to the union. The result is a bloated, politicised industry, regulated to suit the farmers (who nevertheless remain poor), while making it hard for sugar mills to turn a profit. It is no surprise that Mexico's 58 sugar mills have yo-yoed in and out of public ownership. They are now privatised, for the second time in 15 years.

By law, mills must buy cane at 57% of the market price of refined sugar; and they must buy all the cane from a catchment area around each mill. These rules make it impossible for mills to compete, says Mr Cortina. But after President Vicente Fox threatened to veto a law reaffirming them, union protests brought the centre of Mexico City to a halt for a few days last month. Mr Fox backed down, making only minor changes which were then approved by Congress.

Neither Mexico nor the United States is keen on free trade in sugar. The industry was relegated to a last-minute addendum to the North American Free Trade Agreement. The United States wants to restrict exports of subsidised Mexican sugar, but it wants to export its own subsidised corn syrup (a cheaper substitute for sugar in soft drinks). Last month, the WTO ruled in America's favour, but Mexico still threatens to impose punitive tariffs on imports of corn syrup above a threshold. Mexicans seem certain to have to carry on paying a fortune for their sweet tooth.

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Scandals in Brazil

The loneliness of Lula

Sep 22nd 2005 | SÃO PAULO
From The Economist print edition

Changes in party and Congress

Get article background

AFP

The president watches as more allies fall

THE corruption scandals that have transfixed Brazil since May have cost the president, Luiz Inácio Lula da Silva, some of his most stalwart allies. He is about to learn who will replace them. On September 21st Severino Cavalcanti, the president of the lower house of Congress, resigned. Mr Cavalcanti, a Lula foe turned friend, departed over claims that he had demanded bribes for a permit for a restaurant in the Congress building. Meanwhile, Lula's Workers' Party (PT) started choosing a new slate of top officials. Its former leaders, firm backers of the president, were forced to resign over claims of illegal financing and votes-for-cash.

The new party leadership looks set to be a weakened version of the old. It may be more critical of Lula's orthodox economic policies but not unremittingly hostile. With most of the 272,000 votes cast by party members tallied, Lula's candidate, Ricardo Berzoini, was the front-runner to become the PT's president but his “Majority Camp” will have to change its name. Mr Berzoini won just 43% of the vote; he faces a runoff on October 9th, probably against Valter Pomar, a historian, or Raul Pont, a former mayor, both to the left of Lula. But the left may weaken before the final round, partly because several leftist Congressmen are likely to leave the party.

The Majority Camp, inventors of the financing schemes at the centre of the scandals, is nonetheless set to win at least 40% of the seats on the party's policy-making council, which chooses its top officials. Mr Berzoini, should he win, can probably fashion a moderate majority from other factions. He will then have to persuade voters in next year's general election that the PT has reformed without a real purge.

Lula, who did not vote in the party election, is probably more worried about who will replace Mr Cavalcanti. The president of the lower house controls the legislative agenda and, more important, will influence the course of investigations into the PT. Were the job to go to the Liberal Front Party, which holds the interim presidency of Congress and is the most strident opposition force, Lula might be threatened with impeachment, although there is no proof that he blessed illegal party donations. A member of the large Brazilian Democracy Movement Party, part of which backs the government, would be more cautious, especially if polls show the steady fall in Lula's popularity levelling off. Either way, Lula's loneliness would deepen.

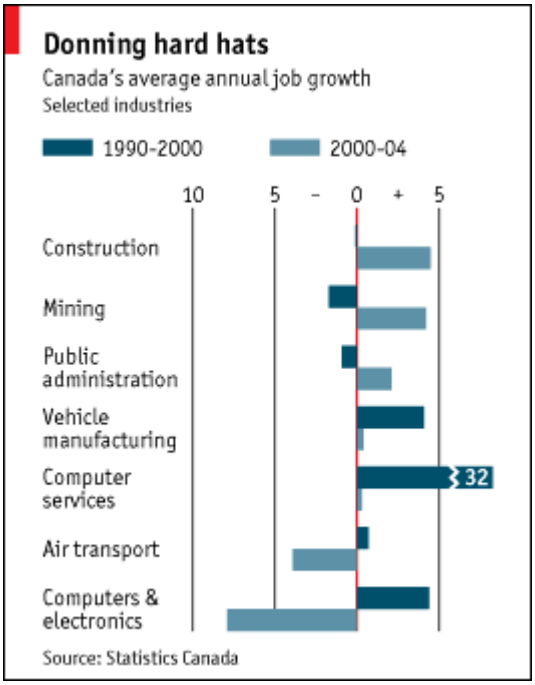
Canada's economy

Of forest and mine

Sep 22nd 2005 | OTTAWA
From The Economist print edition

A return to an older pattern of economic growth

Get article background



CHINA has long held powerful sway over Canada's development. The country was explored by Europeans seeking a passage to Cathay. Trade with the Orient, rather than a desire to build a nation, elicited private money for Canada's transcontinental railway. Now, once again, China—or at least the commodities boom prompted by its industrialisation—is reshaping Canada's economy. The engines of growth in the 1990s—cars and high-tech industries—have slowed or shrunk. In their place, dowdy perennials, such as mining, have become the new stars. "The economy has just been flipped on its head," says Philip Cross, the chief economic analyst at Statistics Canada.

Natural resources, construction and business services (which includes work by architects and engineers) are now the three fastest-growing sectors of the economy. Natural resources, and notably energy, account for more than 60% of Canada's exports (when imported components are subtracted). This is good news for the resource-rich western provinces of Alberta and British Columbia but less so for Ontario, where manufacturing has been hit hard by an appreciation of the Canadian dollar and the continuing troubles of the North American carmakers.

The job market has been turned upside down as well. Youths in rural Canada, where jobs are on offer in mines, oilfields and forests, are now less likely to be unemployed than their urban counterparts. Since 2000, blue-collar work has grown more rapidly than white-collar employment. Workers of all kinds are in short supply in Alberta, where the unemployment rate is about half the national average of 6.8%. The owner of a chain of doughnut shops in the province recently offered workers free iPods, free transport and the chance of a university scholarship if they would just take a job behind the counter.

The soaring price of oil and other commodities has prompted a surge in investment. Some C$46 billion ($39 billion) of new investment was announced earlier this year in Alberta's oil patch alone. Railway lines are being built, ports expanded, and oil and gas pipelines laid. Investment cycles in Canada generally run for seven to ten years. This one is just beginning.

Trade in goods between Canada and China, though growing fast, was still only C$29 billion in 2004 (compared with C$600 billion for two-way trade across the border with the United States). Hu Jintao, China's president, said during a visit to Canada earlier this month that he wanted to see

trade double in the next five years. He singled out energy, natural resources, technology and nuclear power as areas of special interest. But China's biggest impact on Canada has been the influence of its headlong economic growth on commodity prices. High prices for commodity exports lifted Canada's trade surplus to a near-record C$66 billion last year.

These economic shifts are not without complications. There is growing tension over how to share out the wealth generated by natural resources. Some Canadian politicians, like their counterparts in Latin America, sniff an opportunity to play China off against the United States, for example by rerouting lumber and energy exports west instead of south. Just what the benefit of doing this would be is unclear.

Foreign-exchange dealers now treat the Canadian dollar as a petrocurrency. That points to its current strength, but raises two fears. One is of eventual bust when oil prices fall. The other is of what economists call “Dutch disease”, a condition in which primary exports lead to a strong currency which squeezes local manufacturers.

Worst of all is the blow to national pride. After decades of trying, Canada seems to have failed to become a whizzy, high-tech economy. Its main exports to China include humdrum chemicals, metals and minerals. Yet the grief seems overdone. After all, it still produces gizmos such as BlackBerrys as well as gas.

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Venezuela and the United States

And now it's drugs

Sep 22nd 2005 | CARACAS
From The Economist print edition

Mixed signals from Hugo Chávez

Get article background

AS IF they didn't have enough to argue about already, the United States and Venezuela are now at loggerheads over illegal drugs. On September 15th, George Bush's administration announced that it was “decertifying” the leftist government of President Hugo Chávez, lumping it with Myanmar as a country that had “failed demonstrably” in the past 12 months to fight drugs.

This has little practical effect. There is almost no aid to cut, and Mr Bush ruled that the United States would continue funding opposition groups and election monitoring. It is also a fight in which Latin Americans will sympathise with Mr Chávez. “Certification”, in which the world's largest consumer of illegal drugs casts judgment on others, is so widely reviled that it has been played down by American officials in recent years.

Nevertheless, are the American charges right? Venezuela is not a big drug producer, but the United States' Drug Enforcement Administration (DEA) estimates that around 150 tonnes of Colombian cocaine pass through each year on their way to Europe and the United States. Venezuela's National Guard claims to seize about a fifth of that. But this claim is hard to verify.

Non-American sources say there is mounting corruption among the drug-fighters. A “cartel” of National Guard generals is suspected of easing the passage through Venezuela of several tonnes of drugs a month. Relations with the DEA began to sour when a suspect general was appointed to head the National Guard anti-drugs command. A trafficker wanted in the United States walked out of police headquarters after bribing guards. Several civilian officials trusted by the Americans were removed. Mr Chávez accused the DEA of violating accords, espionage and even drug-trafficking. The National Guard pulled out of a joint anti-drugs task force, and the president went on to suspend the agreement with the DEA.

Although Mr Chávez lambasted the United States at the United Nations last week, he may not want a showdown over drugs. This month, some of the generals under suspicion were quietly removed from their posts. He has offered a fresh agreement to the DEA, one vague enough—say those who have seen it—to permit a deal, whilst retaining the option of a complete split in the future.

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North Korea

The deal that wasn't

Sep 22nd 2005 | BEIJING
From The Economist print edition

An agreement with North Korea started to unravel before the ink was dry. But it is still better than a break-down

Get article background

“THE proof, so to speak, is going to be in the pudding.” Thus America's secretary of state, Condoleezza Rice, mangling a perfectly good proverb, but being judiciously cautious about a supposed agreement this week by North Korea to give up its nuclear arsenal. That was on September 19th. Within 24 hours, North Korea had made it clear that there had been little if any real agreement. A resolution of the crisis surrounding its declared (and possibly hidden) nuclear weapons programmes appears as remote as ever, though at least the parties are still talking.

After more than two years of tortuous discussions involving North Korea and the powers most closely involved in the region's security—the United States, China, Japan, Russia and South Korea—participants were anxious to produce at least some evidence that their effort was not being wasted. As host of the talks, China was particularly keen for an accord to be reached. The Americans, lacking any satisfactory plan should the talks fail, were ready to endorse a vaguely worded document that would at least hope to keep the diplomatic process alive.

The “joint statement” issued on September 19th at the end of what was called the fourth round of the six-party talks in Beijing, was hardly the “epoch-making” accord that South Korea's doggedly optimistic President Roh Moo-hyun termed it. It was riddled with holes. North Korea, it said, was committed to “abandoning all nuclear weapons and existing nuclear programmes” and returning

“at an early date” to the Nuclear Non-Proliferation Treaty (NPT) and International Atomic Energy Agency (IAEA) safeguards (both of which it renounced nearly three years ago). But there was no mention of just what weapons or programmes were being referred to.

North Korea has refused to confirm what American officials say was its confession to them in 2002 that it has a programme for enriching uranium, a process that can be associated with the manufacture of nuclear weapons. It has admitted only to a plutonium-based weapons-making project. If the two sides cannot even agree on what nuclear programmes exist, the joint statement's declared goal of the “verifiable denuclearisation” of the Korean peninsula cannot be reached.

There are other obstacles. During the talks, the Americans have insisted that North Korea, having proved so untrustworthy to date, forgo even civilian nuclear programmes. But the Chinese sympathised with the North Korean view that it should still have the right to develop civilian nuclear power. Reluctantly, the Americans agreed in the joint statement that the parties would “respect” (though not accept) North Korea's stance. More remarkably, they agreed to discuss “at an appropriate time” the subject of providing the North with a light-water reactor. It is harder to extract plutonium from these than from North Korea's existing one.

The vulnerability of the entire agreement to the reactor issue was displayed on the following day. North Korea demanded that the light-water reactors (it apparently wants two) be delivered before it rejoined the NPT and carried out its other nuclear-scrapping commitments. America's negotiator, Christopher Hill, said at the closing session of the talks that the “appropriate time” for discussing (he did not even say delivering) the reactors would be only after these commitments had been fulfilled and North Korea had demonstrated “sustained” co-operation with NPT and IAEA safeguards—in other words, at a time far in the future.

Despite this impasse, North Korea may well feel that the cards are still stacked in its favour. All five other countries agree that any attempt to resolve the issue by force could plunge the region into a devastating war (and potentially a nuclear one). And it would be extremely difficult to persuade China and South Korea, the North's two most important trading partners, to support any economic sanctions.

North Korea's confidence that it can rely on Chinese and South Korean aid and trade to prop up its tattered economy helps explain its decision earlier this month to tell the UN's World Food Programme (WFP) that its food aid was no longer required. WFP food is currently distributed among 6.5m people in North Korea, more than a quarter of the population. Tony Banbury, the agency's director for Asia, says the WFP hopes for a deal that will allow it to continue supplying the neediest even after the end-of-year deadline set by the North for the cessation of handouts.

This slap at the WFP should give pause to anyone optimistic about North Korea's willingness to open its doors to nuclear inspection (which, in order to satisfy the Americans, would have to be far more intrusive than it was before the IAEA was ordered out). The real reason for North Korea's decision, analysts agree, is that the government has become increasingly disgruntled with the WFP's insistence on extensive monitoring of aid distribution. China and South Korea are far less fussy. This year South Korea is sending a record 500,000 tonnes of grain with no very vigorous effort to verify its destination.

Only one part of the nuclear agreement stands out as clear and incontrovertible, and that is a consensus that the parties will meet again in early November. Even on this point, there is scope for disappointment. A year ago North Korea backed out of scheduled talks, only sulkily agreeing to return to the table ten months later. More talks, relatively soon, are about the most that can be hoped for now.

Japan's opposition

Maehara's meagre inheritance

Sep 22nd 2005 | TOKYO
From The Economist print edition

A promising young politician takes over a party in disarray

Reuters

Maehara: next in the ring

IT WOULD have been better had he won the job sooner. Alas, before Seiji Maehara could take over as head of the Democratic Party of Japan, the DPJ had to lose another election and its previous leader, Katsuya Okada, had to resign. Unfortunately, Mr Okada did not just perform badly before giving up his post. He first made a terrible decision—to have the DPJ vote against Junichiro Koizumi's postal privatisation scheme this summer—and then let the prime minister run rings around him in the campaign that followed.

So on September 17th, a week after losing more than one-third of their 177 seats in the lower house of parliament, stunned DPJ members chose the 43-year-old Mr Maehara as their new leader. He is the fourth opposition leader Mr Koizumi has faced in his four-and-a-half years as prime minister, and his main task is to find a new role for the battered opposition.

Its previous, self-proclaimed, role now seems irrelevant. That was to foster reform by engineering a change of government and replacing the Liberal Democratic Party (LDP), which has governed Japan almost continuously since 1955. Now that the DPJ has only 113 seats in the 480-seat lower house, those dreams are clearly on hold. Instead, Mr Maehara must settle for trying to hold the LDP to its promises, while gradually restoring some of his party's shattered reputation. In the process, he can still probably do Japan some good.

Mr Maehara will certainly be a match for Mr Koizumi on foreign policy. The prime minister has too often seemed to stray from a laudable version of Japanese assertiveness, involving more confidence and a greater global role, to one that seems needlessly close to an old-style nationalism that does the country no favours.

Mr Maehara has championed the first sort, arguing that Japan should shake off the timidity and self-doubt that have kept its “self-defence forces” from playing a useful role in international peacekeeping. He wants to update some of the rules so that, for example, Japanese troops in Iraq can defend themselves and others more effectively if attacked. While making the case for this sort of modernisation, the articulate and telegenic Mr Maehara may prove adept at taking the prime minister to task for provoking Japan's neighbours by, for instance, visiting the Yasukuni war-dead shrine in Tokyo.

Although it is not Mr Maehara's forte, there will also be important domestic issues to debate. The DPJ's new leader seems wise enough to accept that postal privatisation is not one of them. Voters clearly agree with Mr Koizumi that Japan Post's ¥330 trillion ($3 trillion) of assets no longer belong

in state hands, and have just handed him a two-thirds majority to prove it. Mr Maehara will no doubt point out the flaws in the LDP's implementation during a special parliamentary session this autumn to pass the privatisation bills. But otherwise there is little left to debate.

Instead, Mr Maehara is gearing up for battles over pensions and health care, which voters probably care much more about. On these issues, there is much of substance to discuss. Despite taking helpful steps last year to close a financing gap in the pension system, Mr Koizumi has said little more about either issue publicly. The DPJ will press for more sweeping changes.

Apart from that, the main issues on which the LDP will be tested involve its willingness to shrink the state now that Mr Koizumi has won it a large majority. The DPJ campaigned for deeper cuts than Mr Koizumi has offered, but many of its members are former Socialists who dislike this idea. Mr Maehara may upset them by arguing for more cuts, but he will probably do it anyway. Now that the party is so weak, it matters less that it is also divided.

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Economist.com WORLD ASIA

New Zealand

Not Brash enough

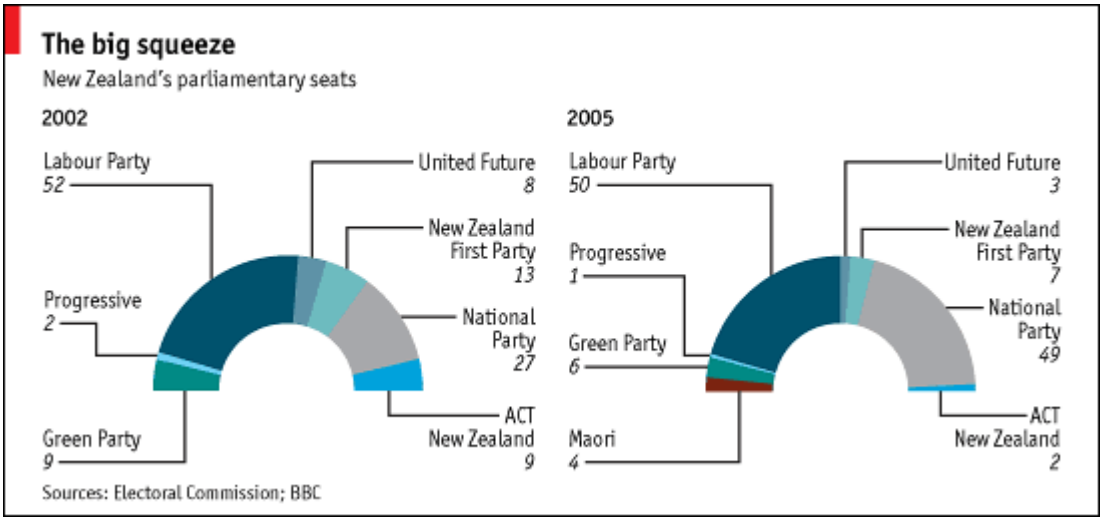
Sep 22nd 2005 | WELLINGTON
From The Economist print edition

New Zealand's opposition narrowly fails to dislodge the prime minister

Get article background

THE polls had predicted a close race, but when New Zealanders learned the preliminary results of their election on September 17th, they were still surprised. The two biggest parties were so evenly matched that the absentee ballots might yet change the outcome. The Labour Party, which headed the outgoing coalition government, pipped its chief rival, the National Party, by fewer than 23,000 votes—with some 218,000 left to count.

The final results will not be known until October 1st, leaving the country in political limbo for two weeks. Labour's current tally would give it 50 of 122 seats in parliament, one ahead of National (see chart). But it also has more potential coalition partners, since the Green and Maori parties are unlikely to throw in their lot with National, while two centrist parties, New Zealand First and United Future, are sticking to their campaign pledge to negotiate first with whichever party turns out to have topped the poll.



Helen Clark, the Labour leader and prime minister of six years, has already begun discussions on forming a government, the electoral impasse notwithstanding. National, led by Don Brash, is hoping that the outstanding ballots might help it draw level with Labour, or pitch the Greens below the 5% threshold required to enter parliament. Thanks to the complicated electoral system, that might even reduce parliament to 121 members, and so decrease the number of seats needed to form a majority. But in the past, smaller parties have tended to benefit from the so-called "special" (mostly absentee) votes more than Labour or National. If anything, the Greens' showing is likely to improve, making things easier for Miss Clark.

Unless the results change dramatically, Mr Brash needs to cut a deal with the Maori Party to have a chance of forming a government—an unlikely prospect, given that National's campaign centred on an attack on special privileges for Maoris. Nonetheless, Mr Brash can claim credit for reversing National's fortunes. Under his leadership, the party has almost doubled its share of the vote. Labour, by contrast, has managed to lose two seats since the last election.

Moreover, National's policies, on Maoris and tax cuts, dominated the campaign. Faced with a surge in National's poll ratings, Labour was forced to offer (smaller) tax cuts of its own, and to sound a harsher note on the status of Maoris. National's strong showing came at the expense of smaller parties, whose vote-share halved. Indeed, some analysts are interpreting the results as proof that New Zealanders have finally got the hang of their proportional electoral system, which was first introduced three elections ago, in 1996.

In the past, they have flirted with all manner of small parties, leaving parliament a patchwork. That, in turn, has allowed the smaller parties to demand a disproportionate influence over policy, and to destabilise governments that refuse. This time, there should be less risk of the tail wagging the dog. Miss Clark has already indicated that she would prefer to lead a minority government, as she has for the past three years, with different parties providing support on different issues.

That would mean continued fiscal prudence, a new push for a free-trade agreement with China, and a doggedly independent foreign policy that will cause occasional friction with Australia and America. But as Mr Brash keeps pointing out, Labour must settle a few matters before it can get down to the business of running the county—including the question of whether it actually won the election.

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Australia

Latham's dire read

Sep 22nd 2005 | SYDNEY
From The Economist print edition

The former Labor leader's diaries show that Australia dodged a bullet last year

Get article background

AUSTRALIANS thought they had seen the last of Mark Latham after he led the opposition Labor Party to its fourth successive election defeat last October. Shaken, and suffering from pancreatitis, Mr Latham resigned from politics three months later. On September 19th, he re-emerged breathing fire with political diaries that have shaken Australia's political establishment, and left the Labor Party surely regretting it had ever been rash enough to anoint him.

“The Latham Diaries” are the most explosive political document Australia has seen in a long time, perhaps ever. His calls for reform in the way political life is conducted are crushed in an avalanche of insults. Mr Latham's description of John Howard, the conservative Liberal Party prime minister, as looking “constipated as usual”, is nothing next to the venom he unleashes on his own party and his former colleagues, especially Kim Beazley, the leader who succeeded him. After almost a decade in opposition, Mr Latham writes, Labor is a “slug of an organisation”, a “museum relic”, a “shitcan”. The only Labor figure Mr Latham commends is Julia Gillard, its feisty health spokeswoman, who he says should lead the party. Understandably, Ms Gillard has distanced herself from the endorsement.

Mr Latham was always a risk for Labor. Only 42 when he became leader in 2003, unattached to any of the party's old power factions, and with a list of weighty books on public policy to his name, he represented a fresh bid by Labor to end a long losing streak. His diaries may end up prolonging its agony. Mr Beazley, still struggling to revive Labor's electoral fortunes, concedes the diaries have “trashed” the party's reputation. Most damagingly, perhaps, the diary reveals the depth of Mr Latham's doubts about the value of Australia's alliance with America, the bedrock of the country's security policy.

Mr Latham's apparent persecution complex did not stop at his party colleagues. As leader, he cold-shouldered the press, which he regarded as yet another enemy, though he has now embarked on a media blitz to promote his diaries. The *Australian*, the paper that serialised them, described the diaries as a “mass of self-deceit and delusion”. They are also an unexpected gift for Mr Howard's conservative government, which will undoubtedly revel in quoting them against the Labor Party—“that thing”, Mr Latham calls it—at the next election, due in 2007.

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India

The fading firebrand

Sep 22nd 2005 | DELHI
From The Economist print edition

But L.K. Advani is not finished yet

Get article background

THE beginning of the change of leadership in India's Hindu-nationalist Bharatiya Janata Party (BJP) has at last been formally announced, but it could be a long time before a new team is in place. After fending off three months of attacks from the BJP's hard-line parent organisation, the Rashtriya Swayamsevak Sangh (RSS) or National Association of Volunteers, Lal Krishna Advani announced on September 18th that he would resign as the BJP's president in December. Normally seen as a loyal follower, Mr Advani fell out with the RSS in June after he had made what they saw as over-generous remarks about Mohammed Ali Jinnah, the Muslim founder of neighbouring Pakistan.

But he will remain parliamentary leader of the BJP and will continue to be seen, along with Atal Behari Vajpayee, the former BJP prime minister, as one of the party's two most senior figures. “They are taller than the rest,” says Vijay Jolly, a BJP activist and president of the Delhi Study Group, a policy organisation. Mr Vajpayee, one of India's most admired politicians, will remain “taller” for as long as he remains active in BJP affairs—though, aged 80, he has made it clear that he has no future party or prime ministerial ambitions. Mr Advani is three years younger (and much fitter) and he would be a prime ministerial candidate if there were to be a general election soon. Polls are not due till 2009, however, so whoever becomes party president in December could have a head start for the top leadership role.

There are six to eight contenders for the president's job, including Sushma Swaraj, a lawyer and former minister and the only woman in the race, and Rajnath Singh, a former chief minister of Uttar Pradesh state. Both are able administrators.

When he announced his resignation, Mr Advani gave warning that the RSS should stop interfering in BJP affairs. That has sparked a new row, which looks like continuing through to the presidency decision in December, and probably beyond. The main beneficiary of this infighting is, of course, India's Congress-led government, which has been spared the attentions of an effective parliamentary opposition at a time when its Leftist coalition parties have been doing an opposition's job of upsetting its economic policies.

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Afghanistan's elections

Democracy, sort of

Sep 22nd 2005 | KABUL
From The Economist print edition

AFP

A messy vote for a new parliament reveals creeping progress

Get article background

IF CHOICE is one fruit of democracy, Afghans might feel they had a surfeit of it in parliamentary and provincial elections on September 18th. In selecting the awkward single non-transferable vote system and dispensing with political parties, President Hamid Karzai's clear aim was to prevent a cohesive opposition emerging. The result, across Afghanistan, was some 5,800 self-interested individuals standing for election; in Kabul, the parliamentary ballot displayed 400 names. If the abiding memory of last year's momentous presidential poll was jubilant scenes, this time it was of perplexed Afghans furrowing their brows as they struggled to select the right box on the ballot to tick.

Some of them failed. One Kabul voter complained that he had been unable to locate Jamil Karzai, the president's reform-minded nephew, on the ballot. He had voted instead, he said, for a candidate previously unknown to him, a doctor, whose postage stamp-sized mugshot revealed a long beard: “He must be educated, and he should be conservative,” the voter explained.

More brightly, the Taliban die-hards fighting in the country's south and east delivered scattered violence, not the inferno they had promised. A dozen people died on polling-day, including a French soldier killed by a roadside bomb in southern Kandahar. At least 19 polling stations were pocked by small-arms fire, while a rocket struck a UN compound in Kabul. But as counting began, it seemed likely that the preliminary results due on October 10th would be deemed “acceptable and credible” by international observers, though no one right-minded would call them free or fair. At a polling site for Kuchi nomads on a dry plain east of Kabul, election workers flagrantly told people whom to vote for. From across the country came reports of intimidation, corruption and logistical glitches in an election that was probably, said the UN team in charge, the most difficult

ever held.

Quite what it will produce is unclear. Though shorn of parties, the parliament is likely to coalesce into three blocks: supporters of Mr Karzai; supporters of his main opponent at last year's election, Yunus Qanuni; and a large and shifting rabble open to persuasion by either side. Whether it succeeds in ruling on the 200-odd decrees Mr Karzai has issued since his election, within 30 days of meeting, as the constitution seems to say it must, should reveal much about its loyalties.

Confusion over the parliament's role and the vote system probably contributed to a reduced turnout: around 50% (compared to nearly 70% in the presidential poll). Another factor was popular outrage at the appearance of many militia commanders, including alleged war criminals, on the ballot. Though 207 well-armed candidates were identified before the poll, only 32 were barred from standing. Nor were allegations of war crimes any hindrance whatsoever. Nearly four years after Italy undertook to rebuild Afghanistan's justice system, the country has a new court-house, a few retrained officials and a single, dubious, conviction for war crimes. At the last count, there were over 1,500 Islamist supreme court judges, many of them illiterate.

That is not untypical of a disjointed multilateral reconstruction effort in Afghanistan. Japan and the UN undertook to disarm militiamen. But without muscular support from American-led coalition troops or NATO-led peacekeepers, they have left thousands of hard cases at large. Britain undertook to reduce opium production, but, with only belated help from America and the government, it failed to stop the past two years yielding record crops. Germany undertook to rebuild the police, but not very seriously: its main achievement—a spanking, first-world academy—has produced far too few officers to affect corruption and incompetence in the force. America, intent on vanquishing the Taliban and al-Qaeda, was slow to realise that unless Afghanistan could one day stand alone, its task will never be done. In the past year, it has accelerated training of the new Afghan army, currently numbering 30,000. Next year, it will spend $900m on training the police.

With so much left undone, the elections should present no excuse for any foreign donor to disengage from Afghanistan. As a rare sign of the future many Afghans want, a pretty 25-year-old parliamentary candidate in Kabul, Sabrina Sagheb, displayed a campaign poster sparkling with sex appeal, and bearing the slogan, “New politics, new world.” Not yet.

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Iraq

The south is a mess too

Sep 22nd 2005 | BAGHDAD AND BASRA
From The Economist print edition

AP

The British-controlled southern zone around Basra was supposed to be calm and fairly contented. But parts of it have descended into ugly chaos

Get article background

BY IRAQ'S recent bloody standards, the violence this week in Basra, the country's second city and its southern capital, was small potatoes. A few protesters were shot dead and a police barracks stormed by British troops after Iraqi police arrested, and then refused to release, two of their comrades. Yet it revealed, once again, the alarming potential for chaos in one of the country's most peaceable areas—which, all the more worryingly, happens to be a heartland of the country's Shia rulers and the repository of most of Iraq's oil. For America's more embattled troops, under fire in the Sunni areas farther north, it will be little consolation to know that if, as is often said, the British are better-loved by the locals, the love is quickly lost.

Tensions started boiling on September 18th, when British soldiers arrested the Basra boss of the Mahdi Army, a militia loyal to Muqtada al-Sadr, a fiery Shia nationalist, who twice last year set southern Iraq ablaze. They accused him of organising roadside bombs that have killed nine people, including two British soldiers, in the past two months: a sign perhaps, that Mr Sadr's people are rethinking their always-weak support for the democratic process. This was also signalled by a day of violent clashes across the south after the unveiling of a new draft constitution last month, between Mr Sadr's lot and members of another Shia militia, the Badr brigade, which is backed by Iran and loyal to the dominant party in Iraq's government, the Supreme Council for Islamic Revolution in Iraq (SCIRI). After the arrest in Basra, several hundred Sadr supporters took to the streets, spoiling for a fight.

To their undoubted delight, the next day, Iraqi traffic policemen arrested two British special-forces soldiers in disguise, suspecting that they were spies. Having spread the rumour across the city—and saying they were spying for Israel—the Sadrists persuaded the police to hand the soldiers over to them. British troops then drove an armoured vehicle through the perimeter wall of the police station where the hapless pair had been held, and later sprung them from the private house where they had been taken. A handful of Sadrists were killed in protests, which went on through the week; the British consulate in Basra came under rocket attack for the first time in several months. According to a Basra teacher: “Whether the prisoners were Israeli terrorists or just a bad version of Lawrence of Arabia, the British have shown their disdain for justice.”

Given last year's violence, the altercation was not surprising. Nor was the British willingness to use muscle: as Britain's death toll in Iraq rises towards 100, its troops are much less likely to assume the “soft posture”, doffing helmets and donning berets, that won them praise in the occupation's early days. Not that this is likely to intimidate their foes: with only 8,500 troops, plus a few hundred Italians, Australians and other allies under their command, the British are too few to secure southern Iraq. Nor are the Iraqi Security Forces (ISF) they have trained, mostly several thousand police, up to the task. Peace prevails in the south, as this latest episode suggests, at the Islamist militias' decree.

According to Basra's previous police chief, barely a quarter of the city's police are dependable. Most are probably moderate—and they do a reasonable and improved job of combating petty crime. But they will not stand against the militiamen in their ranks, who are a very bad lot indeed. At least two journalists, one American and one Iraqi, have been murdered in Basra in recent weeks: both were investigating the militias' activities, which include running protection rackets and assassinating rivals, before their bodies are dumped in a rubbish tip on the edge of the city known as “the lot”. When not thus engaged, the militias rigorously enforce Islamist strictures, beating up women who show an ankle or attacking students enjoying an innocent picnic. A British officer struggled to sound upbeat this week. “There's an unstable sort of stability in Basra,” he said.

The city's governor, Muhammad al-Waili, does not paint a much happier picture. He condemned Britain's actions as “savage, barbaric and irresponsible.” Mr Waili is a member of Fadhila, an Islamist party that fell out with Mr Sadr and has close ties with the ayatollahs in Iran's holy city of Qom.

Badrists v Sadrists

Yet Basra may be the most tightly controlled of the four southern “British” provinces. Of the rest, Muthanna, home to a small Australian garrison, is fairly tranquil, but dominated by the local officials of SCIRI. Farther east, much of Maysan, bordering Iran, including the city of Amara, near where six British military policemen were killed in 2003, is out-of-bounds to British troops; SCIRI's Badr Brigades and the Sadrists vie for control of Maysan as well as neighbouring Dhi Qar province, especially its main town of Nasiriya, where a small garrison of Italian troops is loth to leave its base.

America's government, and many in Iraq's also, like to see Iran's hand in all this. Donald

Rumsfeld, the defence secretary, this week warned Iran not to meddle in Basra. And it does seem likely that individuals in all of Basra's main factions are taking the Iranian rial. Though they spend a lot of time squabbling, Basra's four main parties are all dominated by conservative Shias who would like an Islamist state modelled on Iran. To some extent, each party also sees the British as rivals for power, and wants to see them go.

They may get their wish fairly soon. Britain hopes to quit Muthanna, and perhaps Maysan, this year, and Dhi Qar and Basra next year. As this week's violence shows, it will not be a glorious exit: nowhere in southern Iraq is the central government in firm control. Yet with so few forces to control so vast and vexed a region, the British have never pretended to be doing much more than paper over the cracks.

For their American allies, more is at stake. They are increasingly pushing the better units of the 180,000-odd, mostly American-trained, Iraqi forces to the fore in the counter-insurgency, and with some success. Iraqi troops involved in the attack on the northern town of Tal Afar this month, combining 8,500 Americans and Iraqis, fought much better than those given a rearguard role in the assault on Fallujah last November. But top-class ISF units are still few. “It's certainly our goal that in 2006 the Iraqis are out in front in counter-insurgency operations,” says General John Abizaid, chief of America's central command. “However, I can't tell you that we will achieve that goal.”

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Western Sahara

Give it another try

Sep 22nd 2005 | LAAYOUNE
From The Economist print edition

Hope for resolving Africa's oldest post-colonial conflict

JOHN BOLTON, the new American ambassador to the UN, may not be terribly popular outside the White House. But there is one corner of a sandy foreign field where his appointment is being viewed with some optimism: the Western Sahara, a territory that has been disputed for 30 years. Recent events, however, may revive international interest, even raising hopes that the long stalemate can be broken—with Mr Bolton's help.

When Spain ceded sovereignty of its colony in 1975, Morocco and Mauritania, on either side of it, laid claim. So too did the Polisario Front, an armed nationalist movement which sought to turn Western Sahara (which has lots of phosphate and maybe off-shore oil too) into an independent state for its largely nomadic people. The International Court of Justice at The Hague ruled that the Sahrawis had a right to self-determination, but Morocco sent in its army to occupy the territory. War with Polisario broke out. Tens of thousands of Sahrawis became refugees in camps across the border in Algeria, whose government backed their cause.

In 1991, the UN brokered a ceasefire that called for a referendum on self-determination, but political wrangling—and Morocco's insistence that the many thousands of its own people who had been settled in the territory since 1975 should be entitled to vote—has prevented it from happening. The UN sent James Baker, a former secretary of state, as a special envoy to negotiate a new agreement in 1997. But Morocco, which had agreed in principle to a referendum, rejected his plan; Mr Baker resigned in frustration last year. The stalemate persists.

But things may again be moving. In May, a series of demonstrations in the capital, Laayoune, and elsewhere in Western Sahara and Morocco degenerated into violence and led to the arrests of many Sahrawis and long prison sentences for dozens of them. Since then, there have been more protests and more people arrested, including Ali Salem Tamek, a leading dissident. Two score of Sahrawi prisoners (including a prominent dissident, Aminetou Haidar) have been on hunger strike in Moroccan jails for more than 40 days. Several international delegations and journalists have been deported by Morocco's police on arrival at Laayoune airport.

Liman Ali, Polisario's man in Britain, says the situation is “explosive”. Many Sahrawis, who liken their plight to the Palestinians', now call their growing protest campaign an *intifada* against Moroccan rule. Polisario is getting more encouragement from other African countries; most now recognise Sahrawi statehood, including, recently, Kenya and South Africa.

Morocco and Polisario doggedly stick to their apparently irreconcilable positions. The Moroccans

rule out a referendum, but say they are willing to explore some kind of limited autonomy for Western Sahara. “A federal system would be a wise solution,” says Hamid Chabar, Morocco's proconsul. But for Polisario only a vote on full independence will do.

The UN, still promoting its referendum plan, is again getting involved. In July, Kofi Annan, its secretary-general, asked Peter van Walsum, once a Dutch ambassador to the UN, to take up where Mr Baker left off. Morocco's government, long opposed to loosening its grip on the area, may now be willing to consider a measure of regional autonomy. “The fact that they are willing to look at it seriously is a huge step forward,” says another former UN representative. A further encouraging gesture was Polisario's recent release of 404 Moroccan prisoners-of-war, some of whom had been held for more than 20 years.

Mr Bolton could be the key. He spent three years working with Mr Baker on his plan, knows the issue well, and has already expressed frustration over Morocco's unwillingness to have a referendum. An American congressman, Joseph Pitts, who has long argued for one, says that “having [Mr Bolton] in the UN could push the conflict in the right direction.” But don't expect an early miracle.

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Economist.com WORLD AFRICA & MIDDLE EAST

South Africa's economy

Rather perky

Sep 22nd 2005 | JOHANNESBURG
From The Economist print edition

Growth is fast but jobs are still being created too slowly

Get article background

LAST week, the IMF gave South Africa a thumbs-up in its annual review of the country's economic performance. GDP is growing quite fast (by 3.7% last year, maybe faster this), inflation (3.5% at last count) is under control and public finances are in good shape. The rand has recovered from its 2001 depression, and foreign-exchange reserves are strong. So the Fund is not the only one clapping: business confidence is high. In July, Barclays finalised its R30 billion or so ($4.7 billion) investment in ABSA, one of South Africa's main banks; and in August, Standard & Poor's upgraded the country's credit rating, a few months after Moody's. Yet, despite the government's impressive economic record, too many South Africans are still poor and unemployed—and look like staying so for a long time.

A lot has been done in the past decade. In 1994, the country's first democratically-elected government inherited a distorted, underperforming economy, based on a system that had deprived the majority of the population of education and economic opportunities. Since the end of apartheid, the authorities have steadied the economy and improved fiscal management. They have slimmed the state sector, cut public debt, freed trade and gradually eased exchange controls. In the past four years, the economy has grown by an average of 3.4%, against a dismal 1% during the last 13 years of apartheid. Inflation, since 2003, has been kept within a 3-6% span.

Give us some work, please

Yet, jobs are not being created fast enough to absorb a growing, mostly unskilled, labour force. Unemployment, by a narrow definition, stands at 26.5%; some estimates go as high as 40%. About 10m people, out of South Africa's 47m, live on government handouts. So the government's top priority is to halve unemployment by 2014 and to accelerate annual GDP growth to at least 6%. Training programmes are under way and, in the short term, ambitious public-works projects should help create jobs. State-owned companies are being revamped and investment to improve transport and power should help cut the cost of doing business. But local authorities, short on skills themselves, are struggling to deliver. With local elections coming up, the central government is making a big effort to help them clean up their act.

Yet the government is tiptoeing around the fact that South Africa's labour market regulations make it hard to employ people. According to the World Bank, South Africa scores almost three times worse than East Asian countries on the ease of firing and hiring. Its system of centralised collective bargaining and its complicated minimum-wage structure put a heavy cost on small companies, many of which end up circumventing the rules. But trade unions and the Communist Party, allies of the ruling African National Congress (ANC), are strongly resisting any drastic change. After an ANC meeting in May, reform proposals were put on ice. The Department of Labour has been told instead to contemplate whether labour laws do hinder job creation and to

think about ways of boosting small companies and wooing foreign investors.

The IMF argues that unless the labour market is reformed, the economy is unlikely to grow faster. In July, President Thabo Mbeki appointed a team headed by his deputy, Phumzile Mlambo-Ngcuka, to find a recipe to quicken GDP growth and to cut unemployment. It is supposed to come up with recommendations by the end of this month. But many already know that the answer lies in biting the bullet, rather than looking for a magic one.

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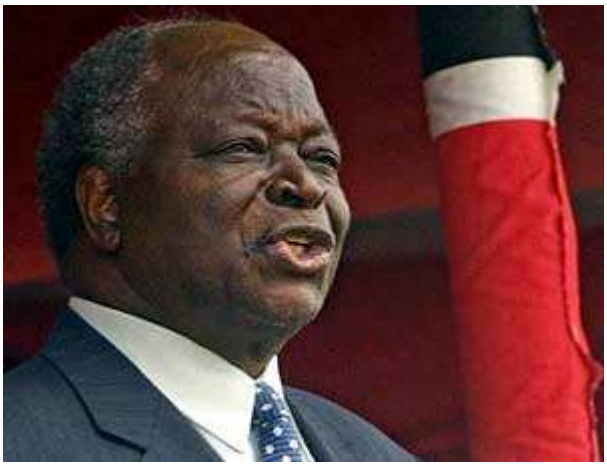
Kenya

Bananas v oranges

Sep 22nd 2005 | BANANA HILL, NAIROBI
From The Economist print edition

Would you like a stronger president or more checks and balances?

AFP



Kibaki wants more juice

Get article background

“NDIZI! Ndizi!” shouted the crowd of mostly young, underemployed men. “Banana! Banana!” Kenya's vice-president, Moody Awori, an Anglican in a Hawaiian shirt, waved a ripe banana. A roar went up through the Nairobi shanty town, appropriately enough named Banana Hill. At the back of the crowd, it was said, a woman had been soundly beaten by a mob for brandishing oranges.

In the run-up to a referendum due on November 21st on Kenya's first proper constitution since independence from Britain in 1963, the country has divided into bananas (yes) and oranges (no). Violence is already rife. The country's electoral commission has tried, without success, to stop any campaigning before its civic-education project can be carried out. Instead, politicians have resorted to incendiary populism, sometimes along tribal lines, to sway voters on a draft constitution few have read and even fewer understand. At an up-country funeral, a banana MP captured the national mood by launching himself at an orange speaker and getting himself wrestled to the ground at the feet of none other than Daniel arap Moi, the former president who was ousted in a poll in 2002 after a corrupt reign that had lasted 24 years.

There are plenty of nits to pick in the draft. Muslims complain it does not allow for their religious courts. Christians as well as Muslims fret that it might, even in the smallest way, condone homosexuality. Kenyans of all stripes, especially those abroad, wonder whether they can have dual nationality.

But the central point, on which fruit is so furiously lobbed, is what sort of presidency Kenya should have. Bananas want a stronger, American-style one. Oranges—a more varied bunch, including

thoughtful civic leaders, acolytes of previous regimes, and opportunists led by the roads minister, Raila Odinga—would like to devolve more power to parliament and to the regions. Mr Odinga's proclaimed outrage positions him for the general election due in 2007. Like many oranges, he thinks the present version has been tinkered with to the benefit of the present president, Mwai Kibaki, with whom he has fallen out.

Whatever side Kenyans choose, they are likely to be disappointed. It is telling how little effort politicians have made to put copies of the draft into the hands of the people. But then Kenyans are used to disappointment. The country's downward drift since independence has been dismal. True, there has been no war and a laudable history of peacekeeping, but that only makes it harder to explain why the country is placed 154 out of 177 in the UN's latest development index. The UN's World Food Programme estimates that 1.2m (out of 31m) Kenyans are on the verge of starvation in the arid north. Mr Kibaki caused donors, appalled by the country's persistent corruption, to rock back in disbelief in New York last week when he made an impassioned plea for Kenya's debt to be forgiven.

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Germany's impasse

A system in crisis, a country adrift

Sep 22nd 2005 | BERLIN
From The Economist print edition

Post-election paralysis has dashed the hope that Germany could build quickly on its economic recovery and embrace reform

Get article background

YOU'VE heard of the perfect storm; now meet the perfect stalemate. After its parliamentary election on September 18th, Germany seems stuck in the worst logjam of its post-war history. None of the coalitions that might form a parliamentary majority look possible. Worse, Gerhard Schröder, the chancellor, and Angela Merkel, the opposition leader, both claim to have won. If no player in this poker game backs down, you can expect a showdown not seen since the Weimar Republic. New elections may be the only way to break the deadlock.

That concern may prove overdone. But even if a stable government does emerge in the days and weeks to come, one thing is already clear: Germany is unlikely any time soon to become the model of a big, rich country that can muster the political courage to reform itself. And the fledgling recovery of Europe's biggest economy could then peter out.

This has been a rude shock for many Germans, especially businessmen. While the margin had been shrinking, most polls forecast victory for the combined opposition of Christian Democrats (CDU) and Free Democrats (FDP). Even days before last Sunday's vote, pollsters said the CDU would top 40%—and that Angela Merkel, the party's boss, would at least be unchallenged to head a big left-right coalition.

Yet when the exit polls began circulating on Sunday afternoon, pundits were amazed. And the final tally confirmed the upset: the CDU and its Bavarian sister party, the Christian Social Union (CSU) came in at only 35.2% of votes, not even a full point ahead of Mr Schröder's Social Democrats (SPD) at 34.3%. The best news for the opposition was the FDP's good showing, just shy of 10%. The Greens and the Left Party, a new amalgam of ex-communists from the east and western lefties, got 8.1% and 8.7% respectively.

Drilling deeper, the results look even worse for the CDU and Ms Merkel. The SPD led the field in 12 of Germany's 16 states, many of which had seen big CDU wins in recent state elections. Most notably, the SPD again overtook the CDU in North Rhine-Westphalia (with 40%, compared with 34.4% for the CDU). It was the SPD's crushing defeat there in the spring that led Mr Schröder to seek early national elections. Yet these gains for the SPD were not enough to compensate for new losses to the Left Party. As a result, neither the governing coalition nor the opposition managed to win the absolute majority of seats needed to elect a new chancellor. This implies one of two outcomes: either the CDU will have to form a grand coalition with the SPD, or each big group must find at least one small party with which to form an alliance. Yet neither the Greens nor the FDP (nobody will talk to the Left Party) appear keen to co-operate.

One big-small combination, called the “traffic light coalition”, would include the SPD (party colour: red), the FDP (yellow) and the Greens. The other would unite CDU, FDP and Greens in a “Jamaica coalition”, so-called because the parties' colours (black, yellow and green) match that island's flag.

What is to blame for this stalemate? For one, a complex election law, giving two votes to each citizen. With their first, they elect half their legislators directly. But it is the second ballot that shapes the composition of parliament, giving Germany a partly proportional form of representation. This was fine as long as there were only two big parties (the CDU and SPD) and one kingmaker, the FDP. Now that both titans have shrunk (their combined result has dropped below 70%) and the Greens as well as the Left party have crossed the 5% threshold for parliamentary representation, building a coalition with a majority has become very hard. In Britain, with its first-past-the-post system, Ms Merkel would now be forming her government, and grooming herself as a German version of Margaret Thatcher.

A nation splits

Yet the messy result and the growing number of parties also reveal splits in German society, especially over economic change. About half of voters want to press ahead (as Ms Merkel wanted), while the other half would prefer to continue muddling through (Mr Schröder's proposal), according to polls taken after the election. This also explains why voters had such a “trembling hand”, says Richard Hilmer of Infratest Dimap, a polling firm. Many clearly changed their minds in the final days, or moments, before the vote.

Perhaps more importantly, the two main camps are also split within, according to Franz Walter, a political scientist at Göttingen University. Many of those who cannot cope with an accelerating, globalising, knowledge-based society (or fear they cannot), he argues, cast their ballot for the Left Party. At the other extreme, the winners in the globalisation game, the “busy burghers”, who are losing patience with slow state bureaucracies, opted for the FDP. This, perhaps even more than the fear of a do-nothing grand coalition, prompted many CDU voters to give their second vote to the liberal, pro-reform party.

Yet the main culprits are probably the two candidates for chancellor themselves—for deepening these rifts rather than trying to bridge them. Ms Merkel now appears to have been the wrong candidate to sell unpalatable reforms. Many see her as disciplined and hard-working, but not likeable or dynamic. The remarried Protestant from eastern Germany may also have scared away

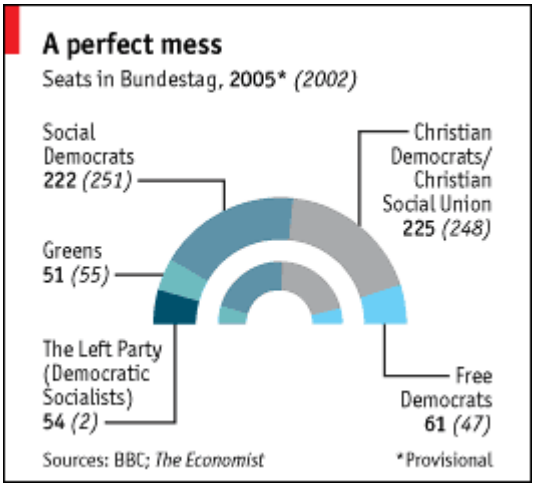
voters in the more Catholic, conservative south. In Bavaria, the CSU vote dropped below 50%—a political revolution in that hitherto one-party state.

The CDU candidate also ran a lacklustre campaign, making many small unforced errors and one big mistake: the nomination of Paul Kirchhof, a judge-turned-professor who favours a flat tax, as her prospective finance minister. This not only confused Ms Merkel's message (her programme included a different kind of tax reform), but also gave the SPD a badly needed boost since it allowed Mr Schröder to switch from a tired defence of his own reforms to an assault on Ms Merkel.

A stiff-necked pair

But it is above all the stubbornness of both the chancellor and his challenger that has led to the current deadlock: both refuse to concede defeat—one with a good argument, the other with a less compelling one. Ms Merkel insists that she ought to lead the next government: the governing coalition has lost and the CDU and CSU now form the biggest parliamentary group. Mr Schröder says he should remain in office: people should see the CDU and the CSU as separate parties—making the SPD the strongest party in parliament.

Even some SPD leaders admit that this argument is questionable (although the CSU has always insisted on its independence when it comes to getting state money). Indeed, Mr Schröder's real train of thought is very different. Although most of the media had already written him off, he has single-handedly achieved the near-impossible with personal popularity and campaign magic: a respectable result for the SPD. To him, it seems, he has won a virtual presidential election.


A perfect mess
Seats in Bundestag, 2005* (2002)
Social Democrats 222 (251)
Christian Democrats/ Christian Social Union 225 (248)
Greens 51 (55)
The Left Party (Democratic Socialists) 54 (2)
Free Democrats 61 (47)
Sources: BBC; The Economist
*Provisional

This is at least how Mr Schröder behaved on election night. He first gave a speech worthy of Caesar to supporters at SPD party headquarters in Berlin. “I'm proud of the people of our country who didn't give in to media manipulation and power”, he said, to loud cheers. Later, in a televised debate, he appeared so punch-drunk that observers were left amazed by the intoxicating effects of victory. He refused to shut up, challenged his journalist interlocutors and seemed to question the whole electoral process: “You can't just demand power for formalistic reasons!”

Yet his behaviour may be more rational than it seems. By confronting the CDU head on, Mr Schröder hopes he can make that party start bickering again and even bring down Ms Merkel. In the hope of encouraging Ms Merkel's rivals to unseat her, he has reportedly offered the CDU a deal like the one made by Israel's main parties in the 1980s: he would remain chancellor for two years, then let a CDU leader have the job.

If this is Mr Schröder's strategy, it does not seem to be working so far. In a show of solidarity, the CDU's parliamentary group re-elected Ms Merkel as their chairwoman with a whopping 98%. Meanwhile, she and the SPD's boss, Franz Müntefering, are both trying to build a Jamaica and a traffic-light coalition respectively. But such efforts are unlikely to succeed: the FDP refuse to form a coalition with the SPD and Greens because it ruled that out during the campaign—a vow that impressed voters. And the cultural gap between the CDU and the Greens is vast. In the words of Joschka Fischer, about to step down as parliamentary leader of the Greens, it is hard to imagine bonding with Christian Democrats over joints and reggae.

Unsurprisingly, there is now feverish speculation about the next move. There is unlikely to be a big shift until October 2nd, when voters in a district of Dresden will cast their ballots. (Voting had to be postponed for two weeks there after the sudden death of a parliamentary candidate.) Contrary to what had been expected, the vote will not deprive the CDU of its place as the strongest party in parliament even if all the district's citizens vote SPD (the CDU may, however, lose a seat if it gets more than 41,226 second votes—another oddity of German election law). Forming a coalition before the Dresden vote, in any event, could cause legal problems that would void the entire election.

What comes next is anyone's guess. Forces of reason hope that Mr Schröder will get off his Gaullist high horse and let Ms Merkel lead a grand coalition. It is also possible that both will step down, letting others take over the reins, most likely Roland Koch, the CDU premier of the state of Hesse, and Peer Steinbrück, the former SPD premier of North Rhine-Westphalia. Such a solution has been dubbed the “Glienicke Bridge”—the place in Berlin where spies were swapped in the cold war.

More likely, Mr Schröder will continue to gamble, forcing a parliamentary showdown. For this, the constitution lays down a clear script. The new parliament has to be constituted at least 30 days after the election, on October 18th at the latest, when it will also vote on a candidate for chancellor proposed by the federal president, Horst Köhler. If this proposal doesn't win an absolute majority, the current chancellor stays in power while parliament has another two weeks to elect the same candidate or another one, with an absolute majority. If this fails, a simple majority suffices—but Mr Köhler must then decide whether to accept the vote or dissolve parliament and call a new poll.

Everybody expects Mr Köhler to propose Ms Merkel, if she has not been dethroned by her own camp. Since she is unlikely to win an absolute majority either on October 18th, or in the two weeks after this first vote, high noon will be in early November: parliament will have to decide whether it wants to keep Mr Schröder or elect Ms Merkel. The incumbent could get votes from the Left Party, while the challenger could win some from the Greens. If this fails to produce an absolute majority, Mr Köhler may well call new elections, either later this year or early in 2006.

Mr Schröder may yet win the biggest gamble of his career. He might, in effect, transform Germany from a parliamentary democracy into a presidential one—recalling what Charles de Gaulle did to France, more formally, when he created the Fifth Republic. That may win the chancellor a place in history, but will it solve Germany's economic problems? In the campaign, he never said what he would really do if re-elected. In any case, he is unlikely to achieve the goal he proclaimed when calling early elections: a stable majority for reform. Last week, it seemed that Mr Schröder might have realised his time at the top was up. But reports of his political death turned out to be exaggerated.

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Italy's finance minister

End of his tether

Sep 22nd 2005 | ROME
From The Economist print edition

The day Domenico's patience ran dry

Get article background

HE WAS a badge of respectability for Silvio Berlusconi's idiosyncratic administration and a guarantee for investors in both Italian securities and the euro. Domenico Siniscalco, a former academic and bureaucrat, ran Italy's finance ministry with skill and vigour, dissuading the prime minister from his more perilous adventures in the field of public finances.

But on September 21st, barely a year after entering the government, he submitted his resignation. Initially at least, this was not formally accepted. One newspaper quoted him as saying: “I couldn't take it any more.” His intended departure propels the conservative government into a renewed crisis, reviving demands from the opposition for a snap election, and calls from within the governing coalition for a change of leader.

Lagging in the opinion polls, Mr Berlusconi and his allies can be expected to agree on the need to resist an early poll. Unless they decide otherwise, balloting for a new parliament will not take place until next spring. But the prime minister's personal credibility, and his reputation for leadership, have been dealt a painful blow by Mr Siniscalco; and his partners are bound to be tempted by the promise of a clean break that offers them at least some prospect of salvaging the next election.

Mr Siniscalco had two motives for his move. The first was the government's handling of the bizarre affair of Italy's central bank chief, Antonio Fazio. He has been accused of conspiring to block attempts by a foreign bank, ABN Amro, to take over an Italian one. Wiretapped conversations published in the Italian press suggested the governor had a close relationship with ABN Amro's rival Italian bidder. Mr Fazio denies any wrongdoing and has repeatedly declined Mr Siniscalco's entreaties to step down.

The trial of strength between the two men was becoming increasingly embarrassing as they prepared to depart for Washington, DC for a meeting of the International Monetary Fund. But, said Mr Siniscalco, the real problem for him was the cabinet's reluctance to put pressure on Mr Fazio to go.

About that, “I'm not embittered—I'm scandalised,” he was reported as saying. The nuance is important. One reason why the government held back was because the Northern League, one of the parties in government, took Mr Fazio's side. There have also been claims—vigorously denied by Mr Berlusconi—that the bidder allegedly backed by the central bank governor had the prime minister's support too.

The other reason behind Mr Siniscalco's farewell—and the one that will concern the markets—was his difficulty in getting his 2006 budget approved within the government. His draft, calling for deficit-cutting measures worth more than €21 billion ($26 billion) was rejected by one of the coalition partners, the Union of Christian Democrats, and many in government are known to feel

such an austere budget would ruin their remaining chances of re-election. The danger clearly raised by Mr Siniscalco's resignation is that, with their eyes fixed firmly on polling day, the spenders will get the upper hand. The 2006 budget must be approved by the government by September 30th, so time is pressing.

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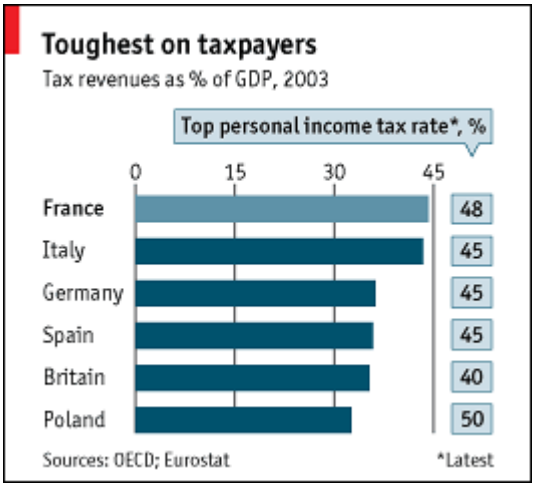
French taxes

When cuts aren't kind enough

Sep 22nd 2005 | PARIS
From The Economist print edition

Less to this than meets the eye

Get article background



FRANCE'S president, Jacques Chirac, took power in 2002 on a pledge to cut income taxes by a third; so far, he's trimmed them by just 10%. So a move by Dominique de Villepin, his prime minister, to simplify France's tax bands and chop the top rate from 48% to 40% sounds impressive. The reality may be less so.

The decision to lower the top tax band was part of a broader overhaul announced last week by Thierry Breton, the finance minister. This will slash the number of income tax bands from six to four, with the lowest rate of 5.5% kicking in on income of €5,515 ($6,700), and a top rate of 40% on earnings of €65,559 or more. By capping the top rate at 40%, the change will make France level with Britain and milder than Germany. While these cuts will not be included in next week's 2006 budget, they will apply on earnings in 2006, taxable in 2007, a presidential election year. “This reform,” says Jean-François Copé, the budget minister, “will profoundly shake up the French fiscal landscape.”

Certainly, the tax plans are an improvement. For one thing, they clarify the structure. Not only will the tax bands be compressed, but a long list of over 400 tax-deductible expenses is also to be trimmed, with a per-household cap on the total paid. For another, the chief beneficiaries should be low-to-middle earners. More than 70% of the tax reductions, says the government, will go to households with income between €10,000 and €40,000. This reflects Mr de Villepin's plan to “make work pay” and discourage spongers.

Yet the plan fails in its other goals: to woo more investors and discourage tax exiles. For sure, cutting the top rate has symbolic value in a country where as recently as 2000, it was 54%. Yet, under France's arcane system, there is a tax exemption for 20% of earnings, so the effective top rate was never as high as the “48%” figure implies. This exemption will now end, so the net change may be marginal. “The aim is for nobody to be worse off,” says one official. “At worst, the effect for top earners should be neutral.”

Given the fiendish complexity of the French tax system, any effort to make it user-friendly should be welcome. But two problems remain. The first is that this reform touches only income tax, not the other host of contributions that choke the tax-payer. According to a study by the Cercle d'Outre-Manche, a French business association in Britain, the average French pay-slip lists more than 40 deductions, compared with just two (tax and national insurance) in Britain. The government says it wants nobody's overall tax bill to exceed 60% of household income; but there is no plan to deal with this fragmentation, or to touch France's anomalous wealth tax.

The other question is the financing of the new tax cuts, which will cost €3.5 billion. Mr Breton says that they will be covered by the €4.5 billion of savings that he will secure by freezing the 2007 budget in volume terms. But public finances are already strained. This week Mr Breton admitted that the government's budget deficit for 2006 would be “in the order of 3%”, compared with a previous forecast of 2.7%. This year, the deficit will be kept to 3% only thanks to a windfall payment from EDF, the state energy company.

In short, amid all the talk of fiscal reform there is a big missing element: spending cuts, above all on the heavy state bureaucracy. For years, the government has vowed to take advantage of demographic change by replacing only one in two retiring civil servants. Yet this has never quite happened. The number replaced in 2004 and 2005? Roughly nine in ten.

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Poland's election race

Right on track

Sep 22nd 2005 | MOGILNO, POLAND
From The Economist print edition

Politics have progressed since 1990 but they have further to go

Reuters

Rokita: PM until the election

Get article background

IN RURAL north-western Poland, a suave, Oxford-educated politician is explaining the advantages of European Union membership. Bad roads are a big problem for Polish farmers, explains Radek Sikorski, a teenage refugee from communism who now runs the transatlantic programme at the American Enterprise Institute, a think-tank in Washington, DC. And EU money is now paying for new ones, helping Polish competitiveness. But a middle-aged woman is unconvinced: “Good roads will help foreigners to come here and buy up all our food,” she protests.

Mr Sikorski patiently explains the principles of supply and demand. He is used to this. The previous day a voter in a spa town complained that Germans were going to “buy up all the water”.

Spending time on the campaign trail in Poland reveals both how far the country has changed since the collapse of communism in 1989—and how far there still is to go. Many voters in this Sunday's parliamentary election are on the same wavelength as the savvy, confident Mr Sikorski, grasping the opportunities that capitalism and democracy have created. They pose sophisticated questions about tax cuts, EU reform and cutting bureaucracy. But there is another chunk of the electorate: fearful of change, muddled and disillusioned.

Mr Sikorski's centre-right Law and Justice party tries to appeal to both camps. His stump speech mixes talk of globalisation and competitiveness with references to his time with anti-communist guerrillas in Afghanistan and Angola in the 1980s. It doesn't hurt that his American wife is also a celebrity: the Polish translation of her book on Stalin's gulag has been a bestseller. All that appeals to patriotic, history-conscious voters, regardless of political orientation.

Other parties cast their appeal more narrowly. The other centre-right outfit, Civic Platform, gains support mainly among well-educated, better-off, urban voters. Its candidate for prime minister, Jan Rokita, is a clever, short-tempered free-marketeer. At a rally in Wolbrom in southern Poland this week, he lashed out against the “lazy cretins” in the bureaucracy, and sternly chastised peasant farmers for their whingeing dependence on handouts from the state.

That is fun to listen to, but may be unwise. Mr Rokita's party was in the lead for most of the campaign. That led his supporters to start calling him, hubristically, “Mr Prime Minister” (which he claims to discourage). But voters find the whiff of intellectual and other arrogance off-putting; now Law and Justice is catching up. One poll this week even showed it moving narrowly ahead.

On the face of it, that makes little difference. Although rivals until polling day, both parties agree they must form a coalition government afterwards. There are close ties already and some joint candidates: Mr Sikorski terms himself bipartisan. Both parties have strong roots in the anti-communist underground; both claim to detest the bloated cronyism which flourished in the post-communist years. “We agree about moral and historical questions,” says Mr Rokita, “but my party is also convinced of the need to liberalise the economy and society.”

That's the rub. Law and Justice says it wants a smaller state, but also makes expensive promises about fairness and social protection, popular causes in egalitarian Poland. It wants to simplify the tax system, while criticising Civic Platform's plans for a 15% flat tax, with some justice, as gimmicky and unfair. But it lacks intellectual fire-power: its policies are flimsy and its two main figures, the twins Lech and Jaroslaw Kaczynski, are noted for their honesty, but also for their charmless stubbornness and limited grasp of foreign affairs and economics.

That portends some big squabbles in the coming weeks over jobs and policies in the new government, particularly over who will be prime minister, and for how long. Even if Mr Rokita's party comes out ahead, many doubt that his brittle, volatile personality will rise to the challenges of running a government.

The dullards, the demagogues and the decent

A short guide to Polish politics

Party	Outlook	Candidate for PM	Candidate for president	Prospects (opinion poll* rating, %)
PO (Civic Platform)	Free-market conservative	Jan Rokita: clever but brittle	Donald Tusk: decent but dull	Majority party in coalition govt (34)
PiS (Law & Justice)	Populist, social conservatives	Jaroslaw Kaczynski: honest but provincial	Lech Kaczynski: honest but provincial	Minority party in coalition (29)
Self-defence	Left-wing populist	Andrzej Lepper: dodgy demagogue	Andrzej Lepper: dodgy demagogue	Opposition (12)
LPR (League of Polish Families)	Conservative, Catholic	Roman Giertych: nationalist demagogue	Maciej Giertych: Roman's dad	Opposition (8)
SLD (Democratic Left Alliance)	Repainted communists	Wojciech Olejniczak: apologetic and youthful	–	Opposition (7)

Source: *The Economist* *For parliamentary elections in *Polityka* magazine

Against that backdrop, Poles will be getting ready for another election next month, for the presidency. Here the Civic Platform's candidate, Donald Tusk, is way ahead of his challenger, Lech Kaczynski, though this probably owes more to his sterling character than his free-market convictions, which few Poles share.

The main lesson of both campaigns is that for the first time since 1989, Poles are arguing more about the future than the past. One big reason is that the once-dominant ex-communist party has

imploded after a series of scandals. Its latest stunt, sending voters automated telephone messages apologising for its past sins, has attracted ridicule. Among the political elite—aside from the small demagogic parties of right and left—there is now a consensus about Poland's way ahead: in the EU but friends with America, with modernity and efficiency instead of incompetence and corruption. Given some of the nutty talk and nasty people seen in Polish politics in past years, that's rather refreshing. It's also pretty ambitious.

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Russia's Far East

Big bears and other extremes

Sep 22nd 2005 | PETROPAVLOVSK-KAMCHATSKY
From The Economist print edition

Amid the earthquakes and volcanoes, at least the power works

SASHA has a General Custer moustache, a middle-aged pony-tail, a revolver under his camouflage jacket and a cigarette welded to his lip. To help on rafting trips on Kamchatka's rivers, he has his wife Katya, and her spaniel; and a sidekick, Oleg, with a big knife, pilots' goggles, and an English vocabulary of one word—“extreme”.

Nine time zones from Moscow, across the Bering Sea from Alaska, the Kamchatka peninsula is twice the size of Britain. Most of its 330,000 residents live in one city, Petropavlovsk-Kamchatsky. The metropolis is not Russia's loveliest. “From up there,” a resident says, indicating the surrounding volcanoes, “it's beautiful.” Down below, it feels designed only for temporary habitation—as it was. In Soviet times, this was a military outpost, closed to other Russians. Residents got regular flights back from what they described as “the island” to “the mainland”.

Even more than in most parts of Russia, living here requires an infrastructure, a “system” which at least sputters along. Nearly 15 years after the communist one collapsed, no matching substitute has been found. “The Soviet system was the best,” sighs Mikhail Mashkovtsev, Kamchatka's governor. When the Soviet Union broke up, the free flights stopped; the region struggled to buy fuel oil for its generators; power and heating became erratic. About a quarter of the population left. The remainder lives largely on fishing: in one recent summer, it is said, the rivers were so thick with salmon that tractors were needed to drag them out. But for most people here, Kamchatka's finest products, such as crab, are too expensive to buy. Life also brings problems that money cannot solve: occasional volcanic eruptions, more frequent earthquakes, and winter.

So there is some Chekhovian longing for Moscow in Petropavlovsk—but many stay on devotedly. Oleg, Sasha's sidekick, tried life in the central Russian city of Nizhny Novgorod, but lasted only a

few years. Away from its hideous capital, Kamchatka's draw is strong. Slabs of fallen ice in the sulphurous crater of a volcano look like broken Brobdingnagian porcelain, hardened lava spills like molten chocolate. Up the volcanoes and in the hot springs, the isolation is total. On the river, in Sasha's raft, it is disturbed only by the odd poachers' dinghy—and by bears fishing for spawning salmon. “Extreme!” says Oleg, as a giant specimen lollops ashore and Sasha reaches for his fire-crackers.

Kamchatka's bears, they say, are the biggest, and its salmon and mushrooms are the tastiest. But the weather may be too unreliable for large-scale tourism, even in the brief summer, and the infrastructure too poor. An old joke about Russia having no roads, only directions, is still popular.

Back in the 1990s, Russians told another joke: they should attack America and then surrender, in the hope of being occupied. In the patriotic era of President Vladimir Putin, that sort of humour is out of fashion, even here. One serious idea, floated by Mr Putin's regional envoy, is to entrust Kamchatka to a businessman—who would pump in money, just as the tycoon Roman Abramovich has done as governor of nearby Chukotka. Locals are sceptical. “Cakes should be made by a cook, and shoes by a shoemaker,” Nikolai Tokmantsev, the speaker of Kamchatka's parliament, says about mixing business and politics. But Mr Tokmanstev calls Mr Putin a “gatherer of the lands”: an old Russian term for a leader who strengthens the nation. The president's main appeal lies in not being his predecessor, Boris Yeltsin. Now the power works, says Sasha the rafter; we're not ashamed to see the president on television, says Katya. Still, nobody expects much from Moscow. Why do people seem nicer in Kamchatka than in the capital? “We have to help each other,” Katya says, “because if we don't, who will?”

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Ukrainian politics

Old ghosts and new

Sep 22nd 2005 | KIEV
From The Economist print edition

Corruption scandals still plague Kiev's would-be revolution

Get article background

SOME people trace the start of Ukraine's “revolution” to 2000, when Georgi Gongadze, a journalist, was murdered; then-president Leonid Kuchma was implicated by secret tape-recordings (doctored, said Mr Kuchma); and crowds took to the streets, albeit smaller than the ones who helped Victor Yushchenko win the presidency last year. This week, a parliamentary commission again implicated Mr Kuchma and an ex-interior minister, who shot himself in the head (twice) in March, in the newsman's abduction. That casts a shadow over Ukraine's whole political class; even Mr Yushchenko was a loyal prime minister during the Gongadze affair.

Meanwhile, other old faces, and habits, are resurfacing. On September 20th, Yuri Yekhanurov—Mr Yushchenko's proposed replacement for Yulia Timoshenko, the prime minister whom he sacked, along with her cabinet, on September 8th—was narrowly rejected by parliament. Corruption charges involving various sacked officials, which triggered the crisis, are swirling on; a sub-scandal has erupted over the president's alleged ties with Boris Berezovsky, an exiled Russian tycoon.

After a meeting with parliamentary leaders, Mr Yushchenko riskily, but successfully, submitted his candidate to another ballot. He may have bought extra votes by bargaining over the new cabinet, and over a constitutional reform that would shift some power from the president to parliament next year. He was sounding sceptical over that change last week, but most other parties want it.

Even though he got his way, he has been forced into humbling political courtships. Dealing with Victor Yanukovich, an ungracious loser in last year's presidential race, would till recently have seemed absurd—except in Ukraine's shape-shifting political culture. Maybe Mr Yushchenko erred in naming Mrs Timoshenko, a volatile populist, as premier; smearing her after sacking her was foolhardy, though both are sounding milder now.

A gently optimistic view is that the prospect of next year's parliamentary elections made a bust-up in Kiev inevitable. A glum one is that the immaturity of Kiev's politicians, and their ties with big business, may wreck the revolution.

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Economist.com WORLD EUROPE

Charlemagne

An ill wind from Germany

Sep 22nd 2005
From The Economist print edition

Make us reform, but not yet, say Europe's voters

EUROPEAN reformers have greeted the German election result with the desperate optimism of the Victorian Brits, holed up in the Indian city of Lucknow, who hoped against hope for rescue ("Dinna ye hear it?—dinna ye hear it? The pipes o' Havelock sound!"). It was Angela Merkel that failed, they say, not reform. She was a bad campaigner. Her programme was half-hearted because regional barons stifled her zeal. Voters were spooked by fears of a flat tax that was not party policy. Anyway, Gerhard Schröder had governed as a reformer.

All true. And all specious. The fact is that Mr Schröder called the election because his reforms had been rejected (he had lost all but one of the state polls since he announced the changes in 2003). Ms Merkel failed because she wanted to go faster. Contrast the German result with Japan, where Junichiro Koizumi also held a ballot because reforms were being stymied by his party. He won a decisive mandate. Had the German vote shown up similar sentiments, Europeans would now be hailing a boost to reform in a Union that has drifted since its proposed constitution was rejected in May. Instead, the election outcome is a setback for change, and for the whole European Union.

It is a blow to the EU because it means that both France and Germany—its strongest members—are now at risk of paralysis. Defeat in the constitutional vote stripped Jacques Chirac of credibility in Europe. Now Germany's voice will be muffled too. It is unclear who will be its next chancellor, which parties will form its new government and how stable it will be; but in any case, a weakened, introvert Germany seems even less likely than before to lead the EU forward. In a club of 25, of course, France and Germany cannot stitch up European policy as they used to. But it is still unusual, and worrying, when both seize up at once. Both are likely to grow more defensive, whether separately or in tandem. The EU will feel the creeping malaise.

Things could get worse. Over the next two years, the other two big economic powers in the euro area will also hold elections. Next up is Italy, where the leader of the movement challenging Silvio Berlusconi is a former EU commission president. This will tempt the prime minister to run as a Eurosceptic. If he were to win, the lesson from Germany and Italy would be that the key to electoral success in Europe lies either in stressing the need to "balance" reform (as Mr Schröder did) or in bashing the EU. That does not automatically mean the French, who vote for a president in 2007, will go down the same road. But their election campaign may well be fought on familiar (pro- or anti-reform) turf; after all, the referendum in France was dominated by talk of globalisation, economic stagnation and the "Anglo-Saxon" attitudes of the European Commission. Railing against the beasts from Brussels who are ruining our welfare states is becoming standard fare in election campaigns. In country after country, debate about reform is fractious; opposition to it is well galvanised.

That is not the same as saying European electorates have become hostile to liberalisation. The broad voting pattern in Germany was quite close to the one in Britain that produced a solid majority for the reformer Tony Blair. Ms Merkel's coalition got almost exactly the same share of the vote as his Labour Party; the difference in outcome was dictated in part by political systems,

not by a vast contrast between Britons and Germans. It is also fair to add that the rise in the Free Democrats' vote points to a constituency for faster reform in Germany.

But the result is still worrying because it reflects a deep-seated ambivalence among voters across Europe. During the campaign, three-quarters of Germans identified “reform” as the only cure for their country's malaise. On the day, over half plumped for parties campaigning for little or no change. In France, the polls show worries about globalisation are only one of many national preoccupations; meanwhile small firms and shopkeepers are among the most admired institutions. Yet the French still rejected the EU constitution, partly in protest against the very forces of competition they claim not to fear.

A half-grasped nettle

The good news is that many Europeans realise things cannot go on as they are. The bad news is that they are loth to do anything decisive about it. The question is whether this consensus, in favour of doing nothing, will one day lurch towards reform.

The mere fact that Europeans are ambivalent is worth something: it is better than being in denial about the need for change. Resistance to reform is also greater in large countries than small ones, such as the Scandinavian states and the Netherlands, probably because (being small) they are used to external pressures. It is also worth pointing out that EU governments, however queasy, can't avoid at least trying to reform: the constraints that demography places on welfare systems will not go away.

But the fact remains that so long as voters are in two minds about this process, pro-reform majorities will be hard to achieve unless (as in Britain) the electoral system provides one. Ambivalence is likely to continue. What the German election showed is that while Europe's status quo is unsustainable (and voters know it), it is also comfortable, and too many voters enjoy that comfort too much to vote for change.

German voters rightly fretted over unemployment. But they should worry, too, about the *em*ployment rate: just one-third of citizens have full-time jobs; so each worker supports two others, and there are as many people on some form of benefit as in permanent employment. The German case is extreme, but most European states face similar pressures. This is not a sustainable social and economic system. Logically, this situation should go on producing votes against change until things become so bad that, as Britain found in 1979, “there is no alternative”. For the time being, Europe does have an alternative: a genteel but depressing process of stagnation.

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Correction: petrol prices

Sep 22nd 2005
From The Economist print edition

The table with our piece on European petrol prices ("Pumped up," September 17th) showed the price of petrol in Swiss francs, not euros. Sorry.

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Political activism

Party time

Sep 22nd 2005 | BLACKPOOL
From The Economist print edition

Britain's political parties are no longer mass organisations. That matters less than you might think

Get article background

EACH autumn, it is the same. Britain's main parties descend on two or three seaside towns, where MPs frantically deliver speeches and mingle with party activists. The settings for these rituals—this week saw the Liberal Democrats in Blackpool—are oddly fitting. Britain's seaside towns were once popular with throngs of domestic tourists but have since lost their way and are searching for how to reinvent themselves. British political parties used to attract the masses too, but are now over-dependent on a residue of ageing enthusiasts who stick by them despite lacking obvious reasons to do so.

All three main parties worry openly about the state of their organisations. Labour is contemplating a new national network of "supporters" as a way of appealing to those who find full party membership trying. Tony Blair will use part of Labour's conference next week to discuss how to refresh the party. Reversing the decline will be hard, though. Party membership has fallen steadily in all west European democracies (apart from Germany, where reunification temporarily increased interest in politics) and shows no sign of recovering.

The slump has been particularly dramatic in Britain. On one estimate, party membership has tumbled 80-90% over the past 20 years. Figures on membership are less reliable than they ought to be, which in itself is an indicator of how loose party organisation now is. The Conservatives claim to have around 300,000 members, Labour about 200,000 and the Liberal Democrats 70,000. All of them are eclipsed by the Royal Society for the Protection of Birds, which has 1,049,392 binocular-wielding enthusiasts.

How did this happen? For a start, British politics has become less controversial. All three main parties now contain people at the top who believe in breaking up state monopolies in public services and giving power to consumers. All the parties are nervous about raising taxes, while none of them is in a rush to shrink the state.

In the absence of a big political or cultural rift, there are few reasons for people to join parties. Fifteen years ago, Labour conferences were unpredictable affairs, where members would gleefully pass resolutions designed to embarrass the party leadership. Since then, conferences have become more like stage-managed rallies, choreographed around the set-piece of the leader's speech, at the expense of members' scope to influence policy.

Though all three parties lament the decline in their membership, they do not seem to want to give too much power to the faithful. The Liberal Democrat activists can still win the odd scalp, as they did this week when their conference rejected a proposal to privatise the Royal Mail. But when it really matters, even the Lib Dems find ways around the rank and file: "We cheat," says one MP who was involved in writing their last manifesto. The Conservatives have experimented with more

democracy by allowing members to choose the party's leader, but are now trying hard to take this power back.

Another reason for activists to stay at home is the feeble state of local politics. Although Scotland and Wales now have their own assemblies, Britain is still the most centralised state in western Europe. Local government has little discretionary power to raise taxes and spends most of its time managing services that central government tells it to provide. The system has the advantage of making reform easier to pursue nationally, but the cost is to make local politics anaemic and unrewarding.

Not much to celebrate

How much does the decline of the political parties matter? For the parties themselves, the answer is quite a lot. Warm bodies are useful when an election is at hand. At the general election in May, both Labour and the Conservatives had to resort to sending targeted mailshots from their national centres in an attempt to capture the feel of a local campaign. The Liberal Democrats say they will do the same next time, if they can find the money.

Membership subscriptions are also a useful source of cash. Their decline has left the parties more reliant on the largesse of a few big donors. The problem with these is not so much that they leave the parties in thrall to a few wealthy individuals—in fact it is surprising how little big donors seem to get for their money. It is rather that the cheques tend to come in only when there is an election on. The parties then spend the money on urgent advertising campaigns, leaving no funds for rebuilding party organisations in places where they have declined.

Smaller memberships also make the political activists seem different from the rest of the population. “Do not underestimate the significance of a doubled membership,” Mr Blair cooed over the Labour party's serried ranks in 1997. “It puts us in touch with real people, real communities. This is a party of the people, not of pressure groups.” The membership of Labour has since fallen by half, which has presumably had the reverse effect.

But enfeebled parties may not matter so much to the rest of the electorate. In part they are a sign of contentment—what political scientists call “the boredom of success”. Sure enough, party membership increases when people feel there is a big choice to be made. Labour's membership doubled when Tony Blair became leader and frustration with the Conservative government was high. Almost as soon as Labour took power it went into decline again. Labour members had got what they wanted and let their subscriptions lapse.

Weak parties also reflect a welcome decline in class conflict in British politics: at the last election the Tories, once recognised as the party of the establishment, made their biggest gains among poorer voters while suffering among the more affluent and educated, who used to be their main supporters. And weaker identification with parties can be a plus: some of the worst-governed bits of Britain have suffered badly from a tribal instinct among voters that has stilted political competition and led a single party to think it had a monopoly on power.

When voters really need them, parties can be reinvigorated. And when they don't, most voters are content to let them go and play beside the sea.

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Blackpool

Unpleasurable

Sep 22nd 2005 | BLACKPOOL
From The Economist print edition

Why Blackpool still attracts so many tourists

TO AN economist wandering along the long strip of beachfront—where battered trams run past tired attractions, dilapidated eateries and shops all selling the same sticks of rock, novelty underwear and latex Saddam Hussein masks—Blackpool's rude commercial health poses a challenge. Why, when it is such an unattractive place, do 11m Britons pay to go there every year?

One answer is habit. Blackpool's catchment area of tourists has not changed for more than a century. Most visitors still come from north of the Midlands, as they did when Blackpool depended on the factories shutting for Wakes holidays to fill its guest houses. The oxymoron that is the Blackpool Pleasure Beach is visited by 6.2m people each year, making it the land's most popular tourist attraction. It is a good illustration of a phenomenon that interests behavioural economists: how long-established patterns can triumph over powerful motives to change.

A second answer is that Blackpool has adapted well to the challenge of low-cost air travel. Blackpool has some 3,500 hotels and lodgings, more than the whole of Portugal. Rather than competing in the market for holidays lasting a fortnight, where the Mediterranean sun has an unassailable advantage, they now fill their beds by depending largely on people coming for weekend breaks. For the most part, this has also meant going downmarket. There are still traces of the town's old gentility to be found, like the signs in hotels that point discreetly towards the “ladies' powder room”. But much of the cash now comes from the bars that advertise “stag and hen heaven”, as well as the nightclubs that specialise in novelty 1980s evenings for people who have accepted enough two-for-one offers on drinks to want to sing along to Tina Turner songs.

Can Blackpool limp on in its present state indefinitely? Visitor numbers have held up well in recent years, suggesting that it can. A further boost would come if it won the right to host the single supercasino the government has decided to allow as an experiment in Britain. But Blackpool won't find out about that until next year. Until then, the town must rely on its curiously long-lasting charm, and on the fact that even *Homo economicus* can sometimes behave in a way that seems to defy his best interests.

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Economist.com WORLD EUROPE

Free versus pay television

Anyone for Freeview?

Sep 22nd 2005
From The Economist print edition

Free-to-air broadcasters are ganging up on their old enemy, BSkyB

AT A biennial television conference last week in Cambridge, James Murdoch, son of Rupert, worked himself into a temper. On a panel with Mark Thompson, director-general of the BBC, and Charles Allen, chief executive of ITV, he hit out at the BBC's plans for a broadband service, quarrelled with Mr Allen and berated the government for its plan to switch the country to digital television.

James Murdoch has reason to be angry. Providers of TV free at the point of delivery—the BBC, ITV, Channel 4 and Five—are waging an increasingly aggressive campaign against pay TV, especially BSkyB, the company Mr Murdoch runs.

“Free television and pay television have co-existed until now, but many people think the phoney war is over and a real battle between free and pay has just started,” says Simon Walker, controller of corporate strategy and business development at the BBC. Free TV's main weapon is Freeview, a digital-terrestrial platform that allows people to watch more than 30 channels instead of the old analogue line-up of five, for a one-time cost of £60 ($108) or less to buy the box. Freeview has been enormously popular since its launch in 2002, and a quarter of homes able to receive its signal now do so—not far behind BSkyB, which is in 31% of homes. Investors used to think Freeview was a stepping stone to pay-TV, but now it looks more like an alternative to basic pay television.

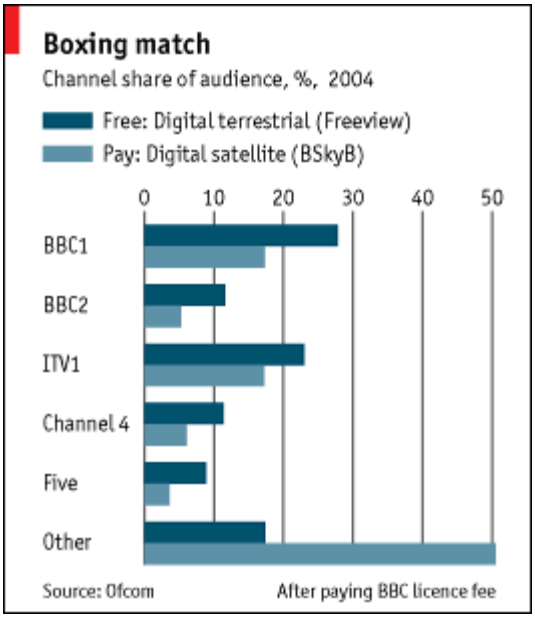
For ITV, Channel 4 and Five, Freeview is a saviour, because although it is more “multi-channel” than the analogue world, it doesn't have that many channels. They lose far less viewing share and advertising revenue in Freeview homes than they would in a world dominated by BSkyB, whose subscribers can surf more than 300 channels. In 2004 the five terrestrial channels collectively won 83% of viewership in Freeview homes, compared with 49.5% in BSkyB households. The BBC's bigger audience share in Freeview homes helps it justify its licence fee.

Free-to-air broadcasters are therefore throwing their weight behind Freeview. Earlier this year Channel 4 decided to forgo pay-TV revenues for E4, its youth channel, and moved it onto Freeview. It soon will launch More 4, another digital channel, on Freeview and ITV will start ITV 4 on the platform. The government, too, supports Freeview as a way to switch off the analogue TV signal beginning in 2008.

Now pay and free TV are competing to buy Flextech, a collection of popular pay channels offered by BSkyB and cable TV which are being auctioned by Telewest, a cable company. David Hulbert, chief executive of Sparrowhawk Media, a media firm, says the pay-TV industry is worried that if Flextech goes to a free-to-air broadcaster, either its channels or their programming could move to Freeview, which would reduce the attractions of pay television. Both BSkyB, and RTL, owner of Five, have reportedly bid for Flextech.

In a direct challenge to BSkyB, the BBC and ITV also

announced this summer that they will launch a free satellite service for the quarter of the population that cannot receive Freeview. The aim, says an executive, is to head off BSkyB's own free satellite service, which he says is a “Trojan horse” for BSkyB's pay products.



How worried should BSkyB be? The satellite initiative from the BBC and ITV does not concern it much. Freeview cannot rival its premium content—sports and movies. Publicly, the firm dismisses free-to-air television's attempts to defend itself in a multi-channel world. In the end, says Richard Freudenstein, its chief operating officer, “free-to-air TV's problem is hyper-fragmentation of its audiences and dilution of advertising and its core revenue”.

But BSkyB is facing other challenges too. It is waiting to find out how the European Commission will ensure that the rights to Britain's Premier League football matches go to more than one broadcaster after 2007 when BSkyB's contract with the league expires. Exclusive carriage of sport has boosted pay-TV around the world, and sharing the Premier League rights—perhaps, even, with free-to-air broadcasters—will be a setback. Secondly, as consumer spending weakens, BSkyB is likely to find it harder to replace the customers it loses each year and grow at the same time.

Until Freeview came along, BSkyB assumed that even with a big, publicly funded BBC, Britain's television market would come to resemble America's, where four-fifths of households choose to pay for hundreds of cable channels. Free-to-air television executives are determined to keep a more equal balance between pay and free TV. From now on, as one of them explains, “the gloves are off”.

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Economist.com WORLD EUROPE

Finishing schools

Manners maketh the man

Sep 22nd 2005
From The Economist print edition

The new interest in etiquette crosses gender boundaries

ACCORDING to Simone de Beauvoir, a woman is not born, but made. For many well-off British girls, a big part of this manufacturing process used to take place at finishing school, with classes in such womanly essentials as deportment, etiquette and flower-arranging.

It is still possible to gain a Diploma in Finishing in Switzerland, where Surval Mont-Fleuri and the Institut Villa Pierrefeu offer a residential course “suitable to the professional aspirations of a modern young lady”. But British finishing schools have closed or turned into business and secretarial colleges.

It seems, however, that mothers still want their daughters to stand up straight and make polite conversation. So Diana Mather and Penny Edge, specialists in corporate recruitment and training, have created The Finishing Academy, offering short courses teaching women and girls to “make the most of themselves”. The talk is about winning business contracts, not husbands, and the cookery is tailored to university life, not gala dinners.

Alongside etiquette and deportment, the courses impart a smattering of self-esteem (public speaking, how to network) and common sense (first-aid, healthy eating), with one-hour sessions on chess, interior design and massage thrown in. The truly vital topics—walking with a book on your head and getting out of a car with your knees together—are covered too. (In case you're wondering, swing your legs out with your knees together, put both feet flat on the ground and push up from the seat.)

Etiquette is even making it onto prime-time TV. “Ladette to Lady”, which aired this summer, showed ten belching, hard-drinking, swearing young women learning to mind their language, walk in heels and host dinner-parties.

And the new interest in etiquette isn't just for women. Some years ago, Sean Davoren, head butler at The Lanesborough, a London hotel, was called on to help to pacify an obnoxious child. He explained the basics of behaving nicely in public, the child was enthralled, the parents told their friends and he found himself holding etiquette classes for children once a month. Demand, even at £45 ($80) a head for two hours, was so high that the waiting list reached 12 months. This year he took a break from teaching to write “Manners from Heaven”, a children's book on etiquette.

Ms Mather and Ms Edge are now planning courses for men. The core subjects of standing, walking and eating are the same as for women, but the add-ons are a little different: map-reading, car-maintenance, fishing, golf, clay pigeon shooting and how to sew on a button. Getting out of a car with your knees together is still for the ladies only, though.

Police reform

Big is beautiful

Sep 22nd 2005
From The Economist print edition

Britain's police forces are about to have a rash of mergers

RATIONALISING Britain's police forces is something that most home secretaries try to do, with scant success. The current arrangement, which has been in place since 1974, is peculiar, not to say perverse—there are 43 independent forces in England and Wales, all of them supposedly equal, even though the largest is more than 30 times bigger than the smallest. Reform has been mooted for a decade, but it now looks inevitable. Charles Clarke, the home secretary, has told police chiefs that they have until the end of the year to come up with proposals to merge into larger units.

Chris Fox, the president of the Association of Chief Police Officers, predicts that no force with fewer than 4,000 officers will exist in a few years' time (currently, four-fifths are smaller than that). Oddly, for someone who represents senior coppers, Mr Fox welcomes the changes. Not because they will save money—he is sceptical about that—but because the nature of crime has changed.

The police tend to distinguish between various kinds of criminality, which, with typical terseness, they refer to as levels one, two and three. Level-one crime is the common stuff like burglary, mugging and car theft. Most of it is crude and takes place within a few miles of the perpetrator's home. Level-two offences involve a bit more planning and travel—a bank robbery, say, or a revenge killing. Level-three crimes are international conspiracies like terrorism and human trafficking.

The middling stuff is what worries the coppers. Humdrum crimes are declining almost everywhere, thanks to better street policing and the ready availability of legitimate ways of earning money. Organised crime and terrorism are not, although that is supposed to be changing: MI5, the domestic security service, is expanding rapidly, and there is a new FBI-style outfit, the Serious Organised Crime Agency. But an increasingly large number of Level-two criminals are slipping through, partly because they are too large to be caught by the neighbourhood coppers and too small to interest the national agencies.

Small police forces have a particularly difficult time catching them—and, in trying to do so, they take their eyes off the common crooks. John Burbeck, the chief constable of the Warwickshire police force, has little more than 1,000 officers at his disposal. When there is a complicated murder or, as happened recently, a turf war among drug dealers who had fled a better-policed city outside his patch, Mr Burbeck must draw officers away from the fight against bread-and-butter criminality. The sort of strategic crime fighting that big police forces go in for, such as cracking down on domestic violence in order to cut the murder rate, is also beyond such a tiny outfit.

It is partly because of such inadequacies that crime is spreading even while it is, in general, going down. Belying their stuffy images, the streets of many market towns are now meaner than those in big cities, which tend to be policed by large forces. In the past year, you were more likely to suffer a violent attack or have your car broken into in Norwich or Peterborough than in London or

Birmingham. Top of the burglary league by a long chalk, with 5.5 break-ins per 100 households, was the smallish city of Nottingham.

For that reason, mergers are desirable. But there is one potential drawback. A common complaint about Britain's police, levelled by the government as well as the two main opposition parties, is that they are remote and unaccountable. If that is true under the present arrangements, it will be more so after they merge. At present, many police forces share their boundaries with city or county governments, which help to set crime-fighting priorities and funding levels. It is difficult to see how a force that straddles as many as ten counties could be held to account in the same way.

It is likely that amalgamated forces will take their lead from the government even more than they do at present. Indeed, Tim Newburn, who follows policing at the London School of Economics, believes the drift towards a single, national police force is now irreversible.

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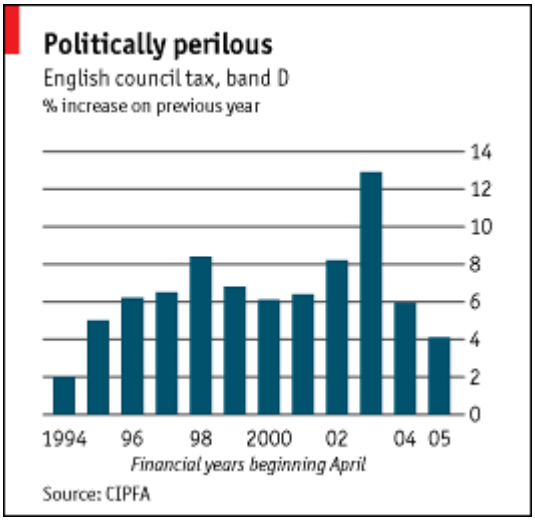
Council tax

Policy paralysis

Sep 22nd 2005
From The Economist print edition

Why Labour has postponed reform of local-government finance yet again

FOR a levy that accounts for less than 5% of total public revenues, council tax arouses high political anxiety. In July 2004 the government shelved any proposals to change Britain's unpopular local residential property tax until safely after the general election. Only four months since Labour was re-elected, ministers have again put off reform, until after the next election due in 2009 or 2010.



The fit of nerves is easy to comprehend, if not to condone. Council tax may raise only a small sum but it is a highly visible one. Furthermore, bills have risen steeply since Labour won power in 1997, with increases peaking in 2003-04 when they averaged 13% across England (see chart). Pensioners, whose incomes are pegged to prices, suffered especially from this run of inflation-busting tax rises.

The protests prompted by soaring council-tax bills alarmed ministers. The Treasury coughed up more money for local authorities from other revenues to avoid further big rises in 2004 and 2005. Where councils dared to raise bills more than the government recommended, ministers stepped in and capped them.

But looming ahead has been a new political danger. Council tax varies according to the value of properties, which are grouped into eight tax-bands. Properties in the top band are charged tax at double the standard “band D” rate and three times the bottom rate. Both the bands and the place of individual homes within them are hopelessly out of date, since they are based on valuations done in 1991.

A revaluation had been scheduled to take place this year, with bills based on these new figures first being issued in April 2007. However, the shake-up was bound to produce losers, even if total council-tax revenue remained the same, as ministers had pledged. Homeowners who have prospered in the property market would be pushed up the band scale, raising their tax bills. While there would also be winners—those whose homes moved down the band scale—protests by the losers could create a political storm.

Now the government has put off revaluation until the next parliament—a Tory proposal in the election campaign that Tony Blair scorned as “desperate opportunism”. Ministers have engineered their U-turn by expanding an inquiry into local-government finance, which they set up to knock the issue into touch before the last election. Sir Michael Lyons, a former city boss and trusted troubleshooter, has been asked to widen his review to take into account the changing role of local councils. On September 20th the government revealed that he will report at the end of 2006,

rather than at the end of this year, as originally planned, and that revaluation will not occur in this parliament.

Fabian tactics of delay have their place in politics, as in war. In particular, there is a strong case for looking at the functions as well as the financing of local government. But the essential problem is already well understood. Council tax accounts for only a quarter of local-authority funding, with the remaining three-quarters coming from the Treasury. As a result, councils have to put up council tax by 4% in order to finance a 1% increase in their budgets.

There are two ways of tackling this instability. One is to allow local authorities to raise new sources of revenue. The Liberal Democrats meeting in Blackpool this week continue to back replacing the council tax with a local income tax. A more plausible option would be to retain the council tax and to restore to local authorities the control over business rates that they lost in 1990. This would mean that they raised about half the revenues needed to finance their spending. However, the reform would infuriate businesses, which fear that they would be stung by unwarranted increases, as used to occur before 1990.

The alternative and likelier way to get a better balance between the power to raise revenue and the responsibility for spending is to cut the functions of local government. The obvious way to achieve this would be to strip councils of their role in education, which accounts for almost 40% of their total spending. As Tony Travers of the London School of Economics points out, by next April the government will already be a long way down this track through policies that will ring-fence school budgets from council control.

There remains a third way: to carry on muddling through with the current unsatisfactory arrangements. Labour's ignominious retreat this week does nothing to boost confidence that this will not be the dismal outcome of its protracted inquiries into council tax.

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Tory leadership

The smart money

Sep 22nd 2005
From The Economist print edition

David Davis has won his most valuable endorsement yet

Get article background

HE HAS yet formally to declare his candidature. But slowly and steadily David Davis is gaining a lock on the Tory leadership contest. Last week saw Mr Davis make a wide-ranging and well received speech on the theme of social justice to New Labour's favourite think-tank, the IPPR. Soon after, Mr Davis won the endorsement of David Willetts, earlier a leadership contender himself and by some way the Conservative Party's most lucid thinker.

Mr Willetts's support is of great importance to Mr Davis, who needs to shed the image of a right-wing toughie. Throughout the summer Mr Willetts has written and spoken about the need for a social dimension to Tory policy and the insights it should be based on. Mr Davis, it is said, has "bought" the argument. Although Mr Willetts played no role in writing the speech to the IPPR, Mr Davis made a point of showing him a draft a few days before giving it. The discussions that followed convinced Mr Willetts, considered by colleagues too pointy-headed to lead the party himself, to throw his weight behind Mr Davis.

Apart from the value of the endorsement, the arguments that swayed Mr Willetts will weigh with other MPs who do not see themselves as natural Davis supporters. Mr Willetts would almost certainly be more personally comfortable with Ken Clarke, the former chancellor, as leader than Mr Davis. But, appropriately for the man known as "two brains", head overruled heart.

While a Clarke leadership would have many strengths—within days of his election, the Tories would be seen as more centrist and register a leap in the polls—its drawbacks, even to a sympathiser such as Mr Willetts, outweigh its merits. Mr Willetts, like other Tories, is sceptical about Mr Clarke's openness to much-needed fresh thinking.

Also, the fear will not go away that his only slightly undimmed affection for Europe would be relentlessly exploited to open Tory divisions by a Labour Party led by Gordon Brown. As one Clarke admirer put it this week: "The first week with Ken would be wonderful. But I worry about the three-and-a-half years that would follow."

The doubts linger, too, about David Cameron. To have won the backing of someone like Mr Willetts, more than ten years his senior, Mr Cameron needed to create a sense of excitement and irresistible momentum. His last chance will be at the party conference, which starts on October 3rd, but his hopes are fading.

Not to put too fine a point on it, an increasing number of MPs will now give their support to the candidate they think is most likely to win. Assuming the election takes place on the existing rules, there is an outside possibility that Mr Clarke could come a respectable second in the MPs' vote and go on to win a ballot of party members against Mr Davis. But both are unlikely. Mr Davis looks more and more like a winner.

Bagehot

The Lib Dems reach a fork in the road

Sep 22nd 2005
From The Economist print edition

It's clear where the Lib Dems should be going; less clear whether Charles Kennedy is the man to get them there

Get article background

NEVER mind that theirs was the only party to increase its share of the vote at the last election; the mood of the Liberal Democrats who met in Blackpool this week is sombre. Despite having returned 62 MPs to Westminster—the party's best result since the 1920s—the Lib Dems are haunted by an overwhelming sense of opportunities missed and fear for the future. Unsurprisingly, the fractiousness is accompanied by grumbles over the leadership of Charles Kennedy—who, until recently, was seen by many as the party's greatest asset.

Some, though not all, of the criticism is justified. Mr Kennedy's leadership style is so laid back that it verges on narcoleptic. This week, conference delegates voted down two policy proposals supported by the party's high command. The first was to limit the size of the European Union's budget; the second to privatise the Royal Mail. Both were of symbolic importance: to signal that the Lib Dems' Euro-enthusiasm was no longer completely uncritical; and to show that the party could be radical on economic issues when it chose.

However, when Mr Kennedy addressed the conference in the aftermath of the two defeats he wittered on about the need for boldness, and, far from confronting delegates with their error, glossed over what had just happened. Pressed in a television interview later in the day, Mr Kennedy blandly suggested that he was still “taking the temperature” of the conference.

The role Mr Kennedy likes to play is of a consensus-builder, a non-executive chairman rather than a hard-charging chief executive. This has worked well enough for him in the past, but it will no longer do. The party faces a choice between sticking with the fuzzy, well-meaning collectivism that many of its activists instinctively espouse and embracing the sharp-edged synthesis of social and economic liberalism that a modernising vanguard of senior MPs is urgently calling for. Mr Kennedy's preferred way of operating is to cleave to the centre, but even he must realise this would be a mistake when faced with a fork in the road.

To Mr Kennedy's credit, he has at least recognised that most of the political and intellectual talent in the party is on the side of the economic liberals—Vince Cable, the heavyweight shadow chancellor, the impressively articulate David Laws and rising stars among the new intake of MPs such as Nick Clegg and Chris Huhne—and has promoted them accordingly. What is less certain is the extent to which he shares their analysis of the party's predicament.

Their view is that the party's solid performance last May overstated its underlying strength. In particular, the dividends from Mr Kennedy's opposition to the Iraq war (the one genuinely brave thing he has done since becoming leader six years ago) are certain to decline. Even if Iraq goes from bad to worse, relatively little of the blame will stick to Gordon Brown when he eventually becomes prime minister.

And the Lib Dems can probably no longer position themselves to the left of Labour, as they have done in the last two elections. As Mr Cable pointed out this week, three or four years from now proclaiming a desire to tax and spend more than Mr Brown may win few votes. As for the Tories, although the Lib Dems are undoubtedly rooting for them to choose David Davis as their next leader, the party's strategists are not counting on him running as inept a campaign as Michael Howard did.

The opportunity, the Lib Dem modernisers argue, is that however hard Mr Brown attempts to woo the crucial middle-England bit of the Blair coalition, he will be seen as a more conventional (and therefore unappealing) kind of Labour leader—above all, as an ardent centraliser and redistributionist. If indeed Mr Davis is the new Tory leader, the Lib Dem modernisers are happy to echo the observation of his leadership rival, David Cameron, that when the going gets tough, Mr Davis would revert to a default setting as a traditionally right-wing Conservative. The gap in the political marketplace, say the modernisers, will be for a party that combines a commitment to social justice and civil liberties with a decentralist and market-led approach to public services.

Of course, there's an element of wishful thinking in all this. Mr Brown and Mr Davis (if it is he) may not oblige in playing the roles allotted to them and the Lib Dems have to become a very different kind of party from the one they are today. But where the modernisers are surely right is in their belief that there is no attractive or credible alternative for the Lib Dems.

A leading question

The question is whether Mr Kennedy is able or willing to lead his party in such a new direction—one from which many of its activists will recoil. Thanks to Iraq, he still has some money in the bank. He would be backed by Mr Cable, by far the party's most authoritative figure, and he would probably have the support of a majority of his MPs. But the task before Mr Kennedy is one that goes against his own nature.

Leaders, such as Margaret Thatcher and Tony Blair, who have brought about big changes in their parties have not spent much time “taking the temperature”. They were driven by a conviction about what had to be done to make their parties succeed. They did not seek consensus; they set out to persuade and, when that failed, to cajole, bully and harangue. They also had the great advantage of having been elected with a mandate to break with the past. Mr Kennedy has no such mandate. The opposite in fact: he replaced a leader, Paddy Ashdown, who prided himself on always being ahead of his party and who had become wearisome as a consequence.

It is likely that Mr Kennedy, who is nobody's fool, knows what he should do. The time is fast approaching for him to ask himself whether he really believes he can do it.

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The great thrift shift

Sep 22nd 2005
From The Economist print edition

America is spending while the rest of the world is saving. But for how long? Zanny Minton Beddoes investigates

ON MARCH 10th 2005, Ben Bernanke—a former Princeton professor who at the time was a governor of America's central bank—addressed a gathering of economists in Richmond, Virginia, on America's gaping current-account deficit. Its causes, he argued, were to be found abroad rather than in American profligacy. In particular, Mr Bernanke mused, the world might be suffering from a "global saving glut". The phrase immediately caught on. Like the famous remark about "irrational exuberance" by Alan Greenspan, the chairman of the Federal Reserve, it has since helped to shape the global economic debate.

The idea's appeal lies in the way it ties together two of the most vexing questions about today's economic landscape: why are interest rates so low? And why can America borrow eye-popping amounts from foreigners with seeming impunity? According to the IMF's latest *World Economic Outlook*, the global economy will grow by 4.3% this year, slower than in 2004 but still a healthy clip. Strong economic growth is normally accompanied by higher interest rates, but long-term interest rates are at their lowest levels since the 1960s.

At the same time Americans are spending over $700 billion a year more than their economy produces, the equivalent of more than 6% of annual output. As a share of America's economy, this external deficit has more than doubled since 1999. Yet it has had none of the dire consequences for the dollar that Cassandras have been predicting. For the first six months of 2005, the greenback was rising. Although it has slid in recent weeks, the drop has hardly been dramatic.

A "global saving glut" could explain both oddities. If savings are somehow super-abundant, the usual relationship between a strong economy and higher interest rates may no longer hold. And if

the spare cash is mainly abroad, that should allow America to finance its deficit with ease. Rather than signalling American profligacy, the current-account deficit might simply be the counterpart to foreign thrift.

This idea turns much conventional economic wisdom on its head. Policymakers usually worry about too little rather than too much thrift. With populations ageing, the broad consensus has been that people need to build up nest eggs to finance their retirement. Economists reckoned that globalisation would lead to a shortage of capital and hence higher interest rates as millions of Indian and Chinese workers were absorbed into the world economy. If Mr Bernanke is right, all this will need re-examining.

His suggestion that the causes of global imbalances lie elsewhere conveniently deflects attention from monetary and fiscal decisions made by American policymakers. It suggests that Mr Greenspan's loose monetary policy and George Bush's tax cuts are not responsible for the imbalances in the world economy. That may seem a little self-serving, coming from a man who has subsequently moved from the Federal Reserve to become chairman of Mr Bush's Council of Economic Advisers.

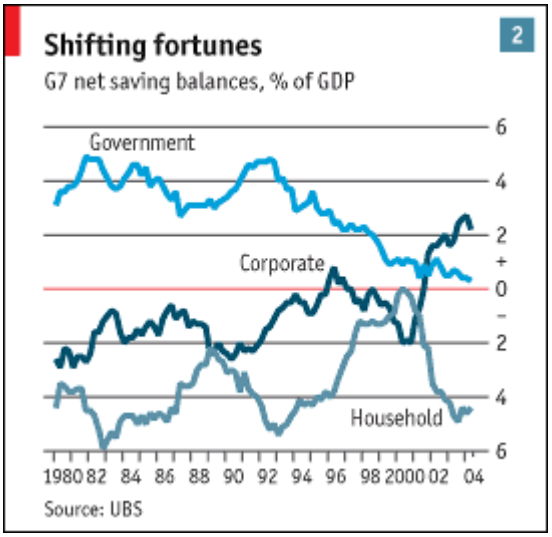
Taken at face value, the notion of a global saving glut is not borne out by the facts. “Glut” suggests an unusually large amount, as in a summer glut of strawberries. In fact, figures published in the IMF's latest *World Economic Outlook* show that the rate of global saving as a proportion of global output, measured at market exchange rates, has mostly been heading downhill over the past 30 years, with a particularly steep plunge between 2000 and 2002 (see chart 1). Although it has since risen slightly, the global saving rate is now close to its average for the past two decades, rather than unusually high.

In search of a glut

But Mr Bernanke's argument is more subtle. He is saying that low interest rates imply too much saving relative to the amount people want to invest, and that the rising imbalance between America and the rest of the world suggests the discrepancy is concentrated outside America. A falling global saving rate could mask substantial divergence between regions. And even with the saving rate falling, there could be a glut of thrift if the demand for the use of those savings, ie, the demand for investment, was falling even faster. The important factors in the equation, therefore, are shifts in the appetite for investment as well as in the geography of thrift.

On both counts the world has seen big changes. Traditionally, most of the saving in an economy is done by households, whereas most of the investing tends to be done by firms. But in the past few years firms have become net savers as their profits have exceeded their investments. That change has been most pronounced and long-lasting in Japan, where corporate saving soared after the bubble economy collapsed in the early 1990s. Burdened with bad debts after a period of massive overinvestment, Japanese firms have been net savers for a decade.

The late 1990s saw a similar shift in many emerging Asian economies, where corporate investment plunged after the Asian financial crisis. After the stockmarket bubble burst in 2000, American and European firms' investment also fell. Although American firms began investing again a couple of years ago, the level of corporate investment is still relatively low, given how strongly the economy—and profits—have been growing. Firms in industrial countries as a whole are still saving more than they invest, despite record profits (see chart 2). The only significant country bucking the trend is China, where investment has been rising sharply. But saving has been growing faster still.



A weak appetite for investment might help explain low interest rates, but not the rising imbalances between America and the rest of the world. To understand those, two other factors have to be considered: differences in countries' economic structures, and differences in policymakers' reactions to the investment bust.

America is at one extreme. Its corporate thrift shift was smaller than that of Japan or other Asian economies, but policymakers in Washington reacted far more dramatically. Between 2001 and 2003, America enjoyed its biggest fiscal stimulus of the post-war period, and short-term interest rates were slashed. Declining interest rates fuelled a boom in house prices, encouraging people to borrow against their properties. Economic growth remained strong and the current-account deficit soared.

Asia's emerging markets faced a much bigger bust, and had fewer policy tools to deal with it. After the 1997-98 financial crisis, investment fell by ten percentage points of GDP. Unable to slash interest rates for fear of further capital flight, they suffered serious recessions. That left exports as their main source of growth. To protect exports and to build up vast war chests of reserves, many East Asian governments kept their currencies cheap for years after the financial crises. Firms stayed reluctant to invest, the saving surpluses remained large and the foreign-exchange reserves piled up.

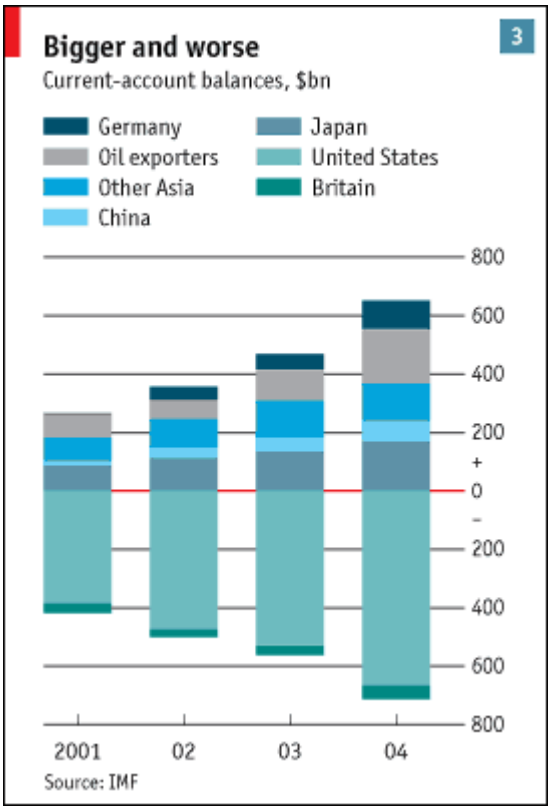
Japan and Europe lie between those two extremes. Politicians in Tokyo tried stimulative policies and talked of structural reform, but proved notoriously ineffective at dealing with their investment bust. The economy fell into deflation and Japan, already the world's biggest exporter of savings, became an even bigger one. Its current-account surplus rose from 1.4% of GDP in 1996 to 3.7% last year.

In Europe, the record has been mixed. Some countries, such as Germany, resemble Japan, with rising saving surpluses and weak domestic demand. Others look more like America. In Britain, fiscal and monetary policy became looser. Spain's current-account deficit is almost as big as America's. Broadly, the countries that saw the biggest rises in house prices also saw the biggest drops in saving.

In short, a good part of the rising imbalances of the past few years can be explained by a series of investment busts—after periods of overinvestment—and sharp differences in the way policymakers responded to them. But particularly since 2000, two other factors have also become important: more saving in China, and the soaring price of oil.

China's investment rate, at 46% of GDP, is the world's highest by far and has been rising fast, but its saving rate has been rising even faster. Between 2000 and 2004, China's national saving rate rose by an extraordinary 12 percentage points of GDP to 50% of GDP. The country has kept its currency cheap and exported ever more capital to the rest of the world.

At the same time, high oil prices have brought a financial windfall to the world's oil exporters which so far they seem to have chosen to save rather than spend. As a group, the oil-exporting countries are now the biggest counterparts to America's current-account deficit (see chart 3).



These shifts have been large and complicated, and they have had important and unusual consequences. The first is that capital now flows primarily from poor countries to rich countries. In

2004, emerging economies, including the newly industrialised economies of East Asia, sent almost $350 billion to rich countries. Yet according to the economic textbooks, capital seeking the highest returns should flow from rich (and capital-intensive) countries to poorer ones that have less of it.

The second consequence is that outside China, less saving by households rather than investment by firms has become the engine of global economic growth. The world economy continues to hum because consumers, particularly American ones, are content to become ever more indebted. That willingness appears closely related to the rapid rise in house prices across much of the globe.

These patterns are a long way from historical norms. Can they last? In the long term, the answer is clearly no. Household saving cannot keep on falling, and America's foreign borrowing cannot keep on rising. The question is when and how the tide might turn.

One camp argues that the saving glut Mr Bernanke has identified is a temporary and largely cyclical phenomenon. As investment recovers in Japan and Europe and strengthens further in America, interest rates will rise. If the investment recovery is concentrated outside America, the surplus savings sloshing in its direction may quickly dwindle. If foreign investors then start fretting about America's dependence on foreign funds, those savings could drain away even more rapidly, sending the dollar down sharply and interest rates up. That would be the classic “hard landing” commentators worry about.

But a growing group of analysts now suggests that the “saving glut” is the result of long-term structural shifts and is likely to last for years, perhaps decades. Some argue that ageing populations in rich countries will mean lower interest rates, because older economies with mature workforces will need less capital and their citizens will save more in preparation for retirement. Others reckon that the Asian economies will continue to export their savings for many years, for mercantilist reasons (keeping their currencies cheap to create jobs in export industries) as well as demographic ones (China, for instance, is ageing faster than America).

If the “saving glut” really is here to stay, there are two main possibilities. The first is that America's consumers will continue to barrel along and the imbalances between America and the rest of the world will increase further. The second is that Americans themselves will start saving again, perhaps because the housing market falters or because high petrol prices begin to bite. With the rest of the world still determined to save too, that would send the global economy into a tailspin.

This survey will try to determine whether the shifts that have caused the “saving glut” are likely to be temporary or more long-lasting. It will conclude that the recent shifts in global saving and investment patterns are not permanent, but nor are they likely to be reversed overnight. Although Japan's economy is looking perkier, and China adjusted its currency regime in July, the surplus of saving from Asia, and from the oil-exporters, is unlikely to fall sharply in the near future. Nor is it likely that the central banks that have been piling up dollar assets will suddenly stop, let alone dump their greenbacks in a hurry. Both factors suggest that America's creditors will probably allow the global imbalances to persist for a while.

All the same, these imbalances are weakening America's economy. They cannot increase indefinitely and will be hard to unwind without sending the world economy into recession. Nudging global saving and investment patterns into a healthier balance will require new thinking, both inside and outside America. Policymakers bear more responsibility for the thrift shifts, and the global imbalances, than Mr Bernanke cares to admit.

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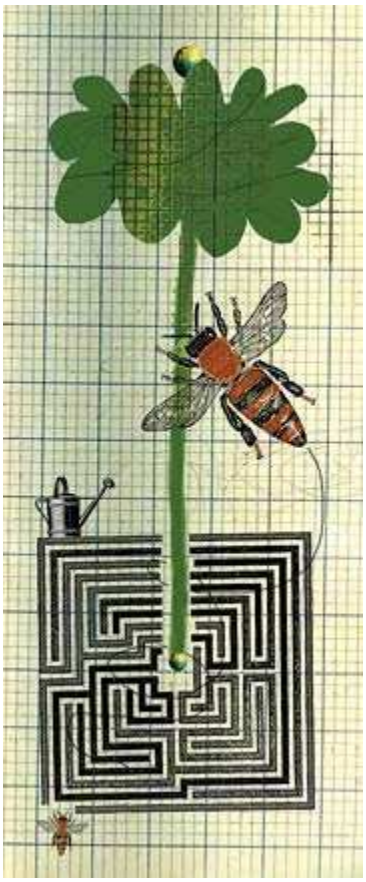
Anatomy of thrift

Sep 22nd 2005
From The Economist print edition

What causes people to save and invest?



AT FIRST sight, the idea of a “saving glut”—an excess of saving over investment—seems odd. According to the economics textbooks, saving and investment are always equal. People cannot save without investing their money somewhere, and they cannot invest without using somebody's savings. Saving and investment are two sides of the same coin.

And indeed that is true for the world as a whole, but it is not true for individual countries. Capital can flow across borders, so the amount an individual country saves does not have to be the same as the amount it invests. The difference between the two is the amount borrowed from or lent to foreigners; this is called the current-account deficit or surplus. If a country's current-account surplus rises, it means that either its saving has increased or its investment has fallen, or both. Either way, that country has generated an excess of saving which it has exported.

Moreover, whereas it is true that at a global level saving must equal investment, the fact that saving and investment end up in balance does not mean that millions of households and individuals spontaneously desire to save and invest in equal measure. To use the language of economics, saving and investment are an “ex-post” identity, but the world's “ex-ante” appetite to save and invest may well be out of balance. Actual saving and investment must be equal. Desired saving and investment may not be.

Most of the time, mismatches between the desired levels of saving and investment are brought into line fairly easily through the interest-rate mechanism. If people's desire to save exceeds their desire to invest, interest rates will fall so that the incentive to save goes down and the willingness to invest goes up. Across borders, exchange rates have a similar effect. If a country has a saving deficit, its currency will fall to the point where its assets are cheap enough to lure foreign savings in.

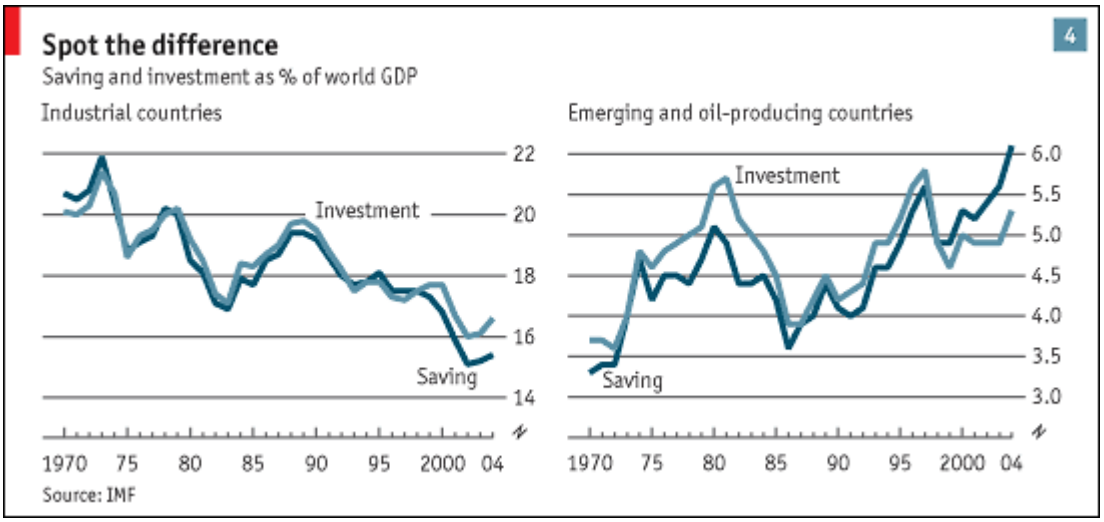
But there is some uncertainty about how smoothly these adjustments are made. Classical economic theory suggests that interest rates automatically bring saving and investment into a productive balance. The central principle of Keynesianism, however, is that this alignment between saving and investment is not always automatic, and that a misalignment can have serious consequences.

If an economy is not running at full capacity, John Maynard Keynes wrote in his “General Theory” in 1936, more saving might, paradoxically, result in less output rather than more. Companies' decisions to produce depend on the demand they expect for their products. More saving means less spending and hence less demand. Hence the idea that you can have too much thrift, and that

there is a place for “Keynesian” government spending policies to boost demand.

It's all true

The modern consensus is that both classical and Keynesian theory can be right, but over different time frames. In the long term, saving and investment will be brought into line by the cost of capital. But in the short term, firms' appetite to invest is volatile, and policymakers may need to step in to shore up demand. Thus, although saving and investment are equal ex-post, economic theory leaves plenty of room for an ex-ante saving glut. This glut could be caused by long-term changes in people's desire to save or firms' desire to invest, or it might be caused by short-term cyclical deviations from normal saving and investment patterns. In either case, the size and duration of mismatches can be influenced by government policy.



What might change people's desire to save or invest? That is a question about human behaviour which economists cannot answer with total confidence. Still, they have made some progress in explaining what motivates investment, and a little more in explaining what drives saving.

The most influential theory of household saving is the “life-cycle hypothesis”, pioneered by Franco Modigliani, an Italian economist. It suggests that people try to smooth consumption over their lifetime: they save little or nothing when young but more in their middle years if they have a good income. They then draw down those savings in retirement. It follows that demographic shifts and economic growth are the most important drivers of thrift.

Another theory suggests that people save for “precautionary reasons”, in case they need the money for a rainy day. This implies that people will save more if their income is variable. It also suggests that they will be more inclined to save if they have no access to credit.

A third possibility is that people save because they want to leave assets to their children, either because they love them or as a way to bribe the children to look after their parents in old age. (Economists are always reluctant to believe in altruism.) Whatever the motive, the bequest theory of thrift suggests that savings might not actually be drawn down in retirement.

A final possibility is that people save in response to their government's actions. This theory, known as “Ricardian equivalence”, suggests that people save more if government saves less because they expect higher taxes later on.

How well do these theories fit with what has actually happened in the past? Saving rates differ dramatically between countries and over time, giving economists plenty of statistical ammunition with which to test their theses. Inevitably, there are differences among academics about which hypotheses are best supported by the data. But, in general, the following factors seem to play a role:

•**Demographics**. Although it is hard to confirm Modigliani's hypothesis by studying individual households, it seems to hold for entire countries. Saving rates do rise when the ratio of children in the population falls (as in China), and decline when the proportion of pensioners rises (as in Japan). Given that the world's population as a whole is ageing but, in most countries, most people are still working, global saving should currently be rising.

•**Economic growth**. Especially in poorer countries, saving rates rise as economies grow. That is probably because people do not adjust their consumption patterns as quickly as their income rises. Rapid growth was an important reason behind the big rise in saving rates in East Asia in the 1970 and 1980s. It may account for much of the rise in saving by emerging economies today.

•**Terms-of-trade shock**. If a country's exports suddenly go up in price, its saving rate tends to go up too, at least temporarily. Oil exporters, for example, put on a saving spurt if oil prices rise. This effect also helps to explain the recent increase in saving in many emerging economies.

•**Financial development**. As an economy's financial system becomes more developed, saving rates tend to fall because people find it easier to borrow. This seems to be true for both rich and poor countries. It suggests that saving rates may be lower in countries with more sophisticated financial systems, such as America.

•**Capital gains**. In rich countries there is increasing evidence that capital gains influence saving rates. If the stockmarket or house prices rise, people feel richer and save less. A study by the OECD published late last yearsuggests that housing wealth has a bigger effect on saving than financial wealth, and that this effect is stronger in economies with flexible mortgage markets and high rates of home ownership.

•**Fiscal policy**. In some countries, people do appear to behave as Ricardian equivalence theory suggests: they save more when budget deficits expand, perhaps because they expect higher taxes in the future, although private-sector saving rises by less than the rise in budget deficits. The big exception is America, where the impact of fiscal deficits on private saving appears to be weakest.

Some of these factors work in opposite directions, and gauging which matters most is difficult. But there are indications that in rich countries the biggest disincentives to saving have been capital gains and the ability to borrow. National saving rates in rich countries have been falling gradually for more than two decades, and particularly steeply since the mid-1990s (see chart 4, previous page). In a recent study for the *World Economic Outlook*, Marco Terrones and Roberto Cardarelli, two economists at the IMF, looked at saving patterns in 46 countries between 1972 and 2004 and found that easier credit (thanks, probably, to higher house prices), along with bigger budget deficits, were the most important reasons for the overall drop in saving in rich countries since 1997.

In emerging markets, on the other hand, the most powerful factors pushed in the opposite direction. Fast economic growth and increases in government saving, thanks partly to terms-of-trade shocks, have increased total national saving.

These opposing movements show up clearly in global statistics. Over the past 35 years, the emerging economies' share of global saving has doubled, from 15% to 30%. In 2004, emerging economies saved the equivalent of 6% of global GDP. If there is a glut of saving, it is likely to be

found in emerging economies and oil-exporting countries.

The investment puzzle

If it is hard to find out why people save, it is even harder to discover why they invest. In theory, firms should invest if the expected return on their investment exceeds the cost of the capital they are using. In the short term, firms need to worry about the state of overall demand. But in the long term, returns on capital depend on how much capital an economy already has, how productively it is used, and how fast the workforce is growing. If there is little capital available or the workforce is growing rapidly, firms would usually expect a high return on investment.

The evidence supports these theories, up to a point. Statistical analyses suggest that investment rises when economies grow, when productivity increases or when the share of workers in the population goes up, and that it slows when capital becomes more expensive. The IMF's analysis, for instance, suggests that a 1% increase in the cost of capital in rich countries will lead to a drop in investment rates of 0.4% of GDP.

However, in recent years these statistical relationships have failed to hold. Both in rich countries and in emerging economies (except China), investment levels have been lower than economists had expected at the levels of interest and growth rates prevailing at the time. Much of Mr Bernanke's saving glut is due to this unexpectedly low rate of investment. This shortfall could simply be the unwinding of earlier excesses as firms repair their balance sheets, but several “structural” explanations have gained support:

•**Demographics**. A young and growing workforce boosts the level of investment, just like a mature workforce boosts the saving rate. So the world economy is likely to move through a cycle in which investment peaks first and saving peaks a bit later. With rising life expectancy and falling birth rates, the world economy may be moving into the high-saving phase. But although demographics are important, they change slowly. It is hard to ascribe the recent sharp drop in investment demand in regions such as Japan or East Asia to demographic change alone.

•**Declining capital intensity**. Firms in rich countries may not need to invest as much as they used to because the share of capital-intensive industries in their economies is shrinking. In a recent analysis, economists at UBS, a bank, pointed out that in America the share of corporate profits that is generated by investment-heavy industries (oil, gas and chemicals, for instance) has fallen from 55% of the total in 1948 to 21% in 2004. This long-term trend may have accelerated over the past decade. But it does not explain investment busts in poor countries.

•**Deflation of capital-goods prices**. In recent years prices of capital goods have fallen sharply relative to prices of other goods and services, thanks largely to cheaper computers, so companies are able to achieve the desired level of real investment for a smaller outlay. Calculations in the IMF's *World Economic Outlook* show that in real terms, the fall in average investment rates in industrial countries has been much more modest than it appears at first sight. This may help to explain some of the recent weakness in investment, particularly in rich countries. But it is unlikely to last. Relative price shifts tend to run their course and then stop. More important, computers depreciate more quickly than other capital goods, so eventually firms will need to invest more to maintain the same level of net investment.

•**The rise of China**. This may have prompted a geographic shift in global investment patterns. As firms move their production to China to take advantage of its huge pool of untapped labour, investment elsewhere slackens. But investment flows to China from America, Europe and Japan are not yet big enough to explain the sluggish investment in those countries. Besides, the rise-of-China thesis is about the location of investment more than about changes in its global level.

In sum, none of these explanations for a structural, global decline in investment is altogether convincing. To understand the pattern of global saving and investment properly, you have to look in detail at what is going on within the world's main saving and borrowing countries. The best place to start is the biggest net saver of all, Japan.

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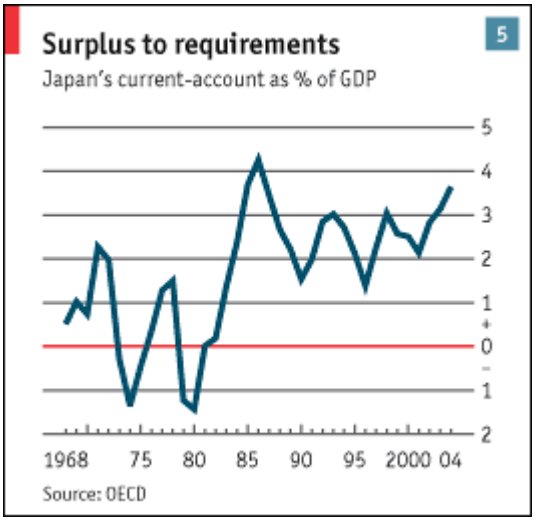
The Viagra economy

Sep 22nd 2005
From The Economist print edition

Japan is getting older but its economy is looking perkier. Will that mean fewer savings to send abroad?

Get article background



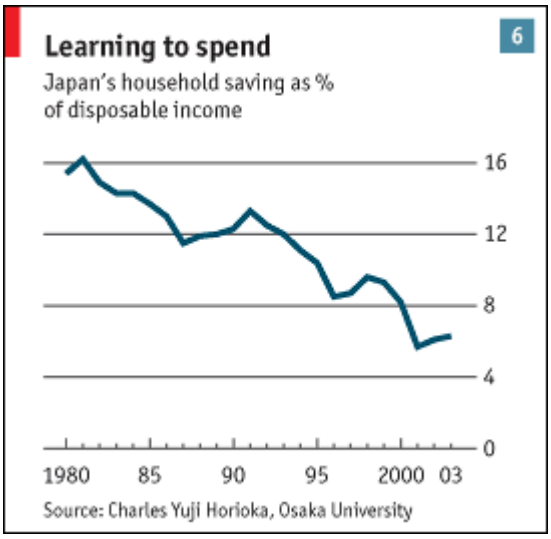
FOR much of the past two decades, Japan has been cast as the villain of the global economy because of its large saving surplus. In the mid-1980s, when America was last running large external deficits, the Reagan administration berated the Japanese for their trade barriers and their unwillingness to consume American goods. In the 1990s, the Clinton administration lectured them for relying on exports instead of sorting out their moribund domestic economy.

Today, in contrast, there is little Japan-bashing, even though as a share of Japan's total economy the country's current-account surplus is now even bigger than it was in the 1990s (see chart 5). Instead, America's attention has shifted to China, with its soaring foreign-exchange reserves and (until recently) fixed currency. But Japan remains an important factor in the global imbalances. Its central bank still holds the largest stash of dollar reserves. A big drop in Japan's capital exports could quickly end the global saving glut. But is that likely?

With only a handful of exceptions, Japan has run a saving surplus every year since the late 1960s, but its underlying saving and investment patterns have varied a great deal. Back in the 1960s, Japan was a young, fast-growing economy, with high investment rates and even higher saving rates. Today Japan is an old, low-saving country. The trouble is that investment is even lower.

In the 1960s and 1970s, the household saving rate soared, giving rise to the idea that the Japanese were peculiarly frugal people. In fact, their behaviour was unexceptional. Charles Yuji Horioka, an economist at Osaka University, argues that the Japanese household saving rate rose sharply in the 1960s and 1970s because the country was growing rapidly; there was little consumer credit; the population was young; and there was little pension provision (Japan had only a modest state pension scheme until 1973).

None of this applies any more. Consumer credit is widely available (Japanese households' debt was 136% of their income in 2000, more than in America). The economy has been stagnant for a decade. And the Japanese have grown old. The share of pensioners in the population is surpassed only by Italy and Sweden. Not surprisingly, household saving has plummeted, from its peak of 23% of disposable income in 1976 to 15% in the 1980s, 10% in the 1990s and around 6% today (see chart 6). Twenty years ago, Japan's household saving rate was almost twice as high as the OECD average; today it is merely average.



Given this drop in household saving rates, why has Japan's current-account remained in surplus? Again, the reasons have changed over time. In the early 1980s, firms were investing more slowly and the government's fiscal position improved. By the late 1980s, private investment was soaring, swept along by the stock and property bubble. The current-account surplus shrank, but remained positive.

Then the bubble burst. Stock prices and then property prices plunged. Investment collapsed and corporate saving rocketed. With Japan's government unable, or unwilling, to clean up the banks' loan portfolios or force restructuring of the weakest firms, Japanese firms have spent the past decade painfully working off their earlier excesses. All profits have gone into improving firms' balance sheets. In the late 1980s, firms were borrowing from households at the rate of almost 10% of GDP a year. For the past decade they have been paying down debt or building up cash balances at a similar rate.

Japan's government, in contrast, has been dis-saving for a decade. Japanese politicians like to blame failed Keynesian stimulus packages; in fact, the country's budget deficits were caused mainly by economic stagnation. With growth weak and prices falling, tax revenues plunged. For the past ten years the budget deficit has been running at an average of 6% of GDP, and Japan's levels of government debt are now by far the highest of any rich country. But even record budget deficits and falling household saving could not counteract the scale of corporate thrift. Japan's current-account surplus has been rising.

Will that change? The answer hinges mainly on whether Japanese firms start investing again. Optimists have been repeatedly disappointed over the past ten years. There were a few mini-recoveries, but they relied on export growth rather than domestic investment, and none lasted long.

Land of rising investment?

But now the mood in Tokyo is more upbeat, and for good reason. The economy has been growing at a respectable rate for two years. After ten years of painful adjustment, corporate balance sheets are looking healthy. The banking system has been cleaned up. Firms are beginning to hire again and wages are picking up. The jobless rate is at its lowest level for seven years. Even land prices in Tokyo are beginning to rise. All this suggests that domestic investment could recover. Given Japan's demographics and its firms' memory of the past decade, no one expects an investment binge, but a gradual rise is likely.

What about Japanese households? In the long term, demographic pressure will push the saving rate down further as more people retire. But in the short term, household saving could rebound, particularly if people were drawing down savings while the economy was weak. Mr Horioka thinks that demographics will prove the stronger factor, and expects the household saving rate to turn to zero or even negative by 2010. The IMF is more circumspect. In its latest analysis of Japan, it forecasts that household saving will fall to around 3.5% of GDP by 2010, a drop of about 2.5 percentage points from its current level.

Given the improved investment outlook and the secular decline in household thrift, it seems clear that Japan's current-account surplus ought to fall. But Japan's new government is adding a new factor to the equation. With public debt already so high and the population ageing so quickly, Japanese politicians are nervous about their fiscal deficits.

There has already been some fiscal tightening. Spending on public infrastructure, for instance, has fallen sharply in the past couple of years. Moderate tax hikes are slated for 2006 and 2007. Japan's prime minister, Junichiro Koizumi, has promised not to raise the consumption tax under his watch, but no one is ruling out other measures. Much depends on how strong the recovery proves to be. Paul Sheard of Lehman Brothers, an investment bank, reckons that stronger growth in Japan will trigger more fiscal tightening.

Mr Koizumi's landslide election victory on September 11th strengthens that impulse. The prime minister had called the election because the old guard of his party, the Liberal Democrats, opposed the privatisation of Japan's postal savings system, a big financier of poorly allocated public spending. This issue was code for an even larger one: reducing the size of the state, and its borrowing. Now Mr Koizumi has a strong mandate to do more of that.

A tighter fiscal policy will counteract lower household saving and higher investment, so the overall effect on the current-account surplus is hard to gauge. Most official forecasts suggest that Japan's current-account surplus will decline gradually. But Japanese technocrats seem to see things differently. When the Council on Economic and Fiscal Policy, Japan's cabinet-level steering group for the economy, released a set of long-term fiscal and economic projections in January, it actually forecast a bigger current-account surplus in 2012 than today.

The council expects a marked improvement in the government's finances, with the deficit falling from 7% of GDP to around 4%. It sees only a modest drop in Japan's private-sector saving surplus, from 11% of GDP in 2004 to 9% in 2012. If this comes to pass, the current-account surplus could rise to 5% of GDP in 2012. This is only a forecast, but it tempers hopes for a rapid turnaround in Japan's saving surplus.

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The frugal giant

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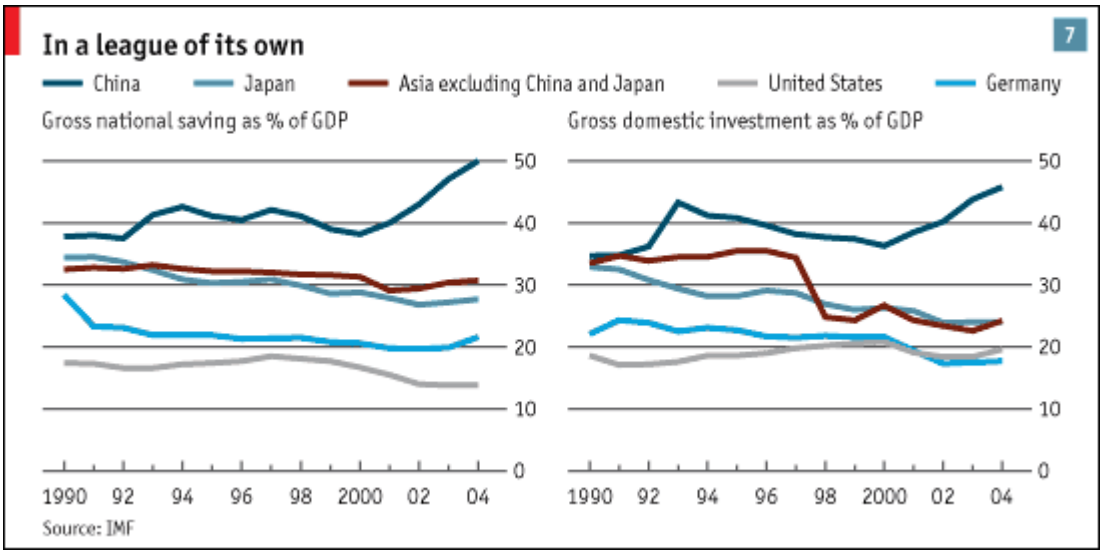
From The Economist print edition

China's enormous saving surplus may rise further before it falls

IN THE Haidan district of western Beijing stands the world's biggest shopping mall. Six storeys high, with 230 escalators and over 6m square feet (558,000 square metres) of retail space, it is a temple to consumption. Over 1,000 shops sell everything from clocks to cats; the “Fantawild Hitech Family Funplex” offers entertainment; an ice-rink beckons.

Only one thing is missing: customers. On a weekday morning in early July, the place was virtually empty, and such visitors as there were seemed to be window-shopping rather than buying. Like the rest of the world, the “Golden Resources Shopping Mall” is still waiting for a big Chinese consumption boom.

Thanks to rocketing economic growth, the Chinese are spending a lot more than they used to. There are now 59 washing machines per 100 households, up from one in 1985. The number of Chinese travelling abroad rose by 43% last year, to 29m. But Chinese saving is growing even more rapidly. Since 2000, the country's overall saving rate—already the world's highest by far—has risen sharply, to nearly 50% of GDP (see chart 7). Even though China is investing at the staggering rate of 46% of GDP, it is still running a net saving surplus, and that surplus is still growing. It rose from 1.9% of GDP in 2000 to 4.2% in 2004, and shows no signs of stopping.



Noting that imports have recently been subdued, many China-watchers expect the country's current-account surplus to rise to 7% or even 8% of GDP in 2005. China may still be poor, but it has become one of the world's biggest exporters of capital. And its impact on the allocation of global capital is even bigger than its current-account surplus suggests. This is because it recycles a lot of savings from other countries and redirects those funds towards America. China is a big recipient of foreign investment ($55 billion of net FDI in 2004), and even more speculative capital has flowed in as investors have been betting on a rise in China's currency, the yuan.

Rather than allow these capital inflows to strengthen the currency, China's central bank has chosen to pile up foreign-currency reserves, many of which are invested in American Treasury bonds. Thanks to its own saving surplus and its recycling of savings, China had $711 billion-worth of reserves at mid-year.

On July 21st, the central bank announced that the yuan would no longer be pegged to the dollar but managed against a basket of currencies instead. After an initial 2% rise against the dollar, the yuan has barely moved, but the change is potentially important all the same. China's new currency regime could affect both its saving surplus in general and its appetite for American assets in particular.

China's capacity for thrift has long perplexed economists. A 2000 study by Aart Kraay, an economist at the World Bank, found that between 1978 and 1995 China's national saving rate was, on average, more than ten percentage points of GDP higher than the country's economic characteristics would suggest. It has since risen further. What is going on?

Thrifty habits

Household saving is the easiest to make sense of. First, Chinese households have not changed their consumption patterns fast enough to keep up with the huge rise in their incomes. The boost to saving from higher incomes has been further strengthened by a rise in income inequality: a large part of China's growing income has been going to the relatively small share of the population living in coastal areas. Richer people save more than poorer ones.

Demography, too, has played a big role, as the share of workers in the population has risen. Moreover, the one-child policy has made it harder for people to rely on their children as a source of support in old age, further encouraging thrift. Franco Modigliani and Shi Larry Cao argue in a

study published in 2004 (posthumously, in Mr Modigliani's case) that these factors together explain virtually all of the rise in Chinese household saving between the mid-1970s and the 1990s.

A further incentive to saving is the weakness of social safety nets. Under the old economic regime many Chinese workers could count on health and pension benefits from state enterprises (the “iron rice bowl”). No longer. The state sector has shrunk dramatically as a share of the economy, and even those workers still employed by state-owned firms have seen their benefits dwindle.

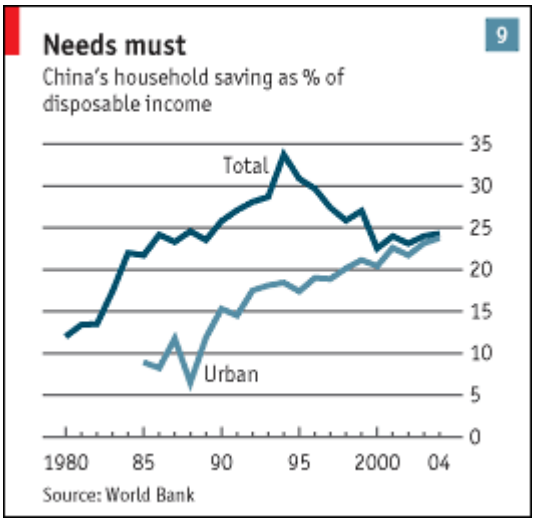
Pension coverage is low: only about 120m people pay into formal pension schemes, fewer than half the estimated 265m urban workers. Worse, pensions are organised largely at the municipal level, and are not easily portable. A migrant worker in Shanghai who plans to retire to his home village cannot assume that he will get his pension there. In rural areas, pensions are almost non-existent.

Health care is also getting more expensive. China's government spends little on public health services and has been shifting costs on to consumers. Enter the lobby of a Chinese hospital, and you might think you are in a bank. A huge electronic noticeboard flashes up the price of treatments—200 yuan for a cardiogram, 101 yuan for an abortion in one Beijing hospital. A row of tellers lines the wall. You pay cash up front. A serious operation can easily cost a year's salary. With state firms reducing their health coverage and private insurance in its infancy, that is another reason for saving.

Education, too, requires deep pockets, even with fewer children. Again, the state spends little on this, around 2.3% of GDP, much less than in Thailand, Malaysia or India. In a recent survey of people's reasons for saving, education came top.

The relative lack of credit is another factor. Although the mortgage market is growing rapidly, thanks to the government's policy of selling off state housing, consumer credit is still in its infancy. Its growth is hampered by the lack of credit-rating agencies and by the ropy banking system. Like the Japanese in the 1960s, the Chinese need to save a lot because they find it hard to borrow.

And save a lot they do. Chinese household saving, at around 25% of disposable income, is astonishingly high by international standards. But although households account for a large part of China's exalted national saving rate, they were not responsible for the sharp rise in national thrift since 2000. After falling steeply in the late 1990s, China's household saving rate has been more or less steady since 2000 (see chart 9). The recent rise in national saving was led by the government and the corporate sector. Louis Kuijs of the World Bank has examined sectoral saving patterns in China and points out that both these sectors are far more frugal than many observers realise.



The fiscal accounts show the government's revenue to be about 20% of GDP and expenditure slightly higher,

resulting in a deficit of about 2% of GDP. But Mr Kuijs
argues that these numbers mask a lot of government saving and investing. The government spends only about 13% of GDP on goods, services and wages. The remainder—almost 10% of GDP—is, in effect, government saving, which is then invested, largely through direct capital transfers for infrastructure projects or to support state firms.

Chinese firms, both state-owned and private, are also big savers. Corporate profits soared after 2000, thanks to rapid growth, low interest rates, rising productivity and cuts in employee benefits. Both private and state-owned firms are flush with cash, so their saving has risen sharply. China's firms are now bigger savers than its households.

But unlike their peers in the rest of the world, they are investing their surpluses. With no need to pay dividends (state firms do not have to make any transfers to central government) and little shareholder pressure to ensure that their investment is cost-effective, Chinese firms went on a capital-spending binge, concentrated in industries such as aluminium, steel, car production and cement.

That splurge may well prove unsustainable. Profit growth has slowed sharply over the past year because of excess capacity in the most over-invested sectors, such as cement and steel. Grace Ng of J.P. Morgan, a bank, points out that whereas in early 2004 overall profits in industrial firms were expanding at the rate of 40% a year, by May 2005 the growth rate had slowed to 16%.

Slower profit growth means less corporate saving, but investment seems to be slowing even faster, at least in the most over-invested sectors. The rate of growth of China's imports of capital goods, for instance, is now less than a third of what it was in 2004. But Chinese firms are still selling the fruit of past investment on world markets. As a result, the country's external surpluses are rising. According to Arthur Kroeber, editor of the *China Economic Quarterly*, the investment slowdown will result in “at least a couple of years of blockbuster trade surpluses”.

How far a cyclical slowdown in investment translates into a rise in China's national saving surplus also depends on how consumers react. If firms create fewer jobs, or even lay people off, consumption could catch a cold—which would mean more saving and even bigger external surpluses. Nicholas Lardy, of the Institute for International Economics in Washington, DC, points out that the last time China had an investment bust, in the mid-1990s, consumption slowed sharply and the current account shifted from a deficit of around 2% of GDP in 1993 to a surplus of around 4% in 1997.

So far, consumption growth has barely been affected this time. Retail sales, for instance, show no sign of flagging. But China's current account was already in surplus when the investment slowdown started, and is rising faster than it did a decade ago, so if and when the effects feed through to consumption, the change in the current account could be much bigger than last time. A saving surplus of 10% of GDP, or even more, is not unthinkable.

Whatever the scale of the current cyclical investment slowdown, the pace of China's investment is likely to fall over the medium term. At an aggregate level, China's investment rates seem inefficiently high. Japan and South Korea, for instance, achieved similar rates of growth in the 1960s and 1980s, respectively, with investment levels that were ten percentage points lower than China's. Although investment efficiency has been improving, particularly in the growing private sector, many state firms—which account for much of the over-investment—still earn negative returns on capital. That will change as market reforms continue. Once Chinese banks, for instance, face foreign competition in 2007, they will care more about whom they lend to. Shareholders will become more active and demand higher returns on capital. The introduction of dividend policies would shift more corporate profit to households.

Will consumers wake up?

Better corporate governance will also reduce corporate saving. What happens to China's national saving surplus will depend on whether China's households will save less and spend more, thus becoming the engine of the domestic economy.

The example of Japan is sobering. Although Japanese households now save much less than they used to, their country never really made the shift from export-led to consumer-led growth. It has been running current-account surpluses for four decades. China, however, is different in important ways. Its economy is already much more open than Japan's ever was. Exports and imports add up to the equivalent of 70% of China's GDP, compared with only 20% in Japan. And if July's exchange-rate adjustment turns out to be the beginning of a gradual appreciation, China seems to be shifting away from an undervalued currency far more quickly than Japan did.

Over time, a stronger currency will encourage a reorientation of China's economy towards the domestic consumer, but this is likely to take several years. Although American policymakers may be clamouring for a rapid rise in the yuan, there is no sign in Beijing that the government plans anything of the sort. China's leaders are concerned about unemployment in urban areas as the export sector is squeezed by a stronger yuan, and they worry about unrest in rural areas as farmers have to compete with cheaper imported grain.

A government that depends on rapid economic growth to legitimise itself will not want to risk instability with a sudden rise in the currency, so a much stronger yuan seems an unlikely route to a quick reduction in China's saving surpluses. Reforms to encourage consumer credit and reduce uncertainty about pensions and health-care costs are a better bet. Some such reforms are already under way. China's central bank, for instance, intends to set up credit bureaus in seven provinces this year to help boost the development of consumer finance, and pilot schemes to improve the pension system are in progress in several provinces. Top Communist Party leaders talk a lot about shifting the emphasis of government spending from investment to social safety nets, and recently they promised free nine-year education for children in rural areas. But the government's overall fiscal position has actually tightened this year.

Redirecting an economy as big as China's towards domestic consumption takes time. China's saving surpluses will not last forever, but nor will they disappear overnight. And trying to move too fast can be disastrous, as the mess in Asia's other emerging markets shows.

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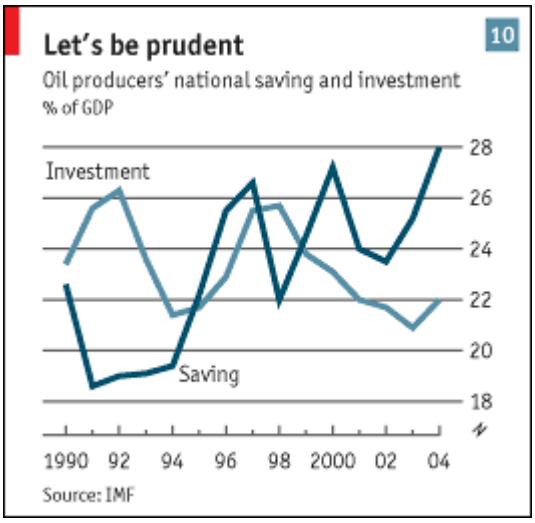
Reversal of fortune

Sep 22nd 2005
From The Economist print edition

Why oil exporters and East Asians are reluctant to spend



JAPAN and China may be the whales amongst the world's savers, but their surpluses add up to only about 40% of America's saving deficit. The rest comes from a shoal of smaller fish. Most are emerging economies, particularly in Asia and the Middle East. These countries are piling up current-account surpluses for different reasons. Saving in oil-exporting countries has soared, and private-sector investment in emerging Asia outside China has collapsed.

The role of oil prices in today's global imbalances is often overlooked, but surplus saving in oil-exporting countries, as a group, is now the biggest counterpart to America's deficit. In 2004, when the oil price averaged $40 a barrel, oil exporters ran a collective saving surplus of $207 billion, almost three times as much as in 2001. So far this year, oil prices have soared, and the IMF now expects the oil exporters' collective surpluses for 2005 to be almost $400 billion. That should not come as a surprise. A sudden windfall of wealth from a “terms-of-trade shock” initially tends to be saved not spent, and national saving rates in oil-exporting countries have recently shot up (see chart 10).

But the oil-producing countries are being unusually frugal. Their investment rates have actually fallen since the late 1990s. Why? First, they believe today's elevated prices to be temporary. If oil prices are likely to fall back to, say, $30 a barrel, it is prudent not to spend the extra revenue. Second, they are determined not to repeat the mistakes made in previous oil booms, when excessive profligacy left many oil producers high and dry as prices fell. In the late 1970s, Nigeria was swimming in petrodollars; by the mid-1980s, it was going cap in hand to the IMF.

This time around the oil-rich countries have created rules to encourage prudence. Several of them now have “oil stabilisation funds” into which windfalls should flow. Others have been shoring up fiscal positions that were looking rather unhealthy at the end of the 1990s, after a long period of cheap oil. Saudi Arabia's government, for instance, has been paying back the debt accrued over 17 years of budget deficits. Russia is paying off its external creditors.

This prudence may not last. Many oil-exporting countries, particularly in the Middle East, have young populations and a huge need for physical and social infrastructure, so investment is likely to rise. But with memories of past oil busts still vivid, that shift may not be sudden.

Where are the tigers now?

The saving surplus in East and South-East Asia is the legacy of a bust both more recent and more spectacular than the 1970s oil shocks: the Asian financial crisis in 1997-98. A decade ago, the regions' economies, from the more developed (such as South Korea) to the poorer ones (such as

Thailand), were in the midst of an investment binge, particularly in property. Several of them became big importers of savings, running current-account deficits of 4% of GDP or more. When the crisis came, investment plunged, from around 35% of GDP to less than 25%. Although it has recently risen a little, it is still extremely low. Overall, the investment rate in East and South-East Asia is now close to the average in Japan, a much richer country.

East Asia's saving surplus, in short, has little to do with increases in saving. National saving rates in the region have remained relatively stable. While corporate saving has risen, household saving in many places has fallen, thanks both to demographics and to government efforts to boost consumption. In 1998, South Koreans saved 24% of their incomes; by 2003, the figure was down to 4%. Thailand's household saving rate fell from 15% of GDP in 1998 to 6% in 2003.

The puzzle is why domestic investment has not recovered more. A big bust was always going to entail a prolonged period of balance-sheet adjustment, and investment rates had never seemed likely to return to their excessive pre-crisis levels. Even so, seven years after the crisis, and with growth in the emerging East Asian countries now strong, it seems odd that investment is still so weak.

One explanation may be that China's rise has resulted in a bigger shift in investment demand in the rest of Asia than elsewhere in the world. Investment in export sectors, in particular, may simply have shifted to China. Sun-Bae Kim of Goldman Sachs, an investment bank, points out that investment rates in emerging Asia as a whole, including China, look much healthier than in the region outside China (see chart 11).

But emerging Asia's biggest investment weakness is outside the export sector. The mystery is that rapid export growth has not translated into higher domestic-sector investment, especially as real interest rates in the region have been low or even negative for much of the past three years.

Most analysts blame Asia's currency policies. They argue that, just as a cheap yuan has recently distorted China's economy, and a cheap yen distorted Japan's in the early 1980s, so the rest of Asia is cursed by its addiction to export-led growth. The proof lies in the region's growing accumulation of reserves, which is a measure of Asians' efforts to hold down their currencies. According to the Bank for International Settlements, emerging Asia outside China increased its reserves by $147 billion in 2003 and $157 billion last year.

Not everyone agrees with this argument. Jonathan Anderson, an economist at UBS, maintains that Asia's central banks are holding their currencies down not in order to boost exports at the expense of domestic consumption, but rather because domestic demand is so weak.

Whatever their motivation, there is no doubt that Asia's central banks worry about the strength of their currencies. The exact circumstances differ from country to country. Except in Hong Kong, no currencies are now tied directly to the dollar. Malaysia abandoned its peg as soon as China did. Nonetheless, most currencies have moved relatively little against the dollar (see chart 12). There is a widespread fear of moving too far, too fast.

Emerging Asia's governments are also leery of other quick fixes to boost domestic investment or spur

consumption. It was, after all, excessive domestic investment—thanks partly to rash liberalisation of the financial sector—that got them into the crisis in the first place. And there have been other fiascos since. In 2000-2002, South Korea tried to stimulate consumption by encouraging consumer borrowing on credit cards. But supervision and credit-rating turned out to be inadequate, so the credit-card boom quickly turned to bust.

Nonetheless, there are some tentative signs of an upturn in domestic demand. The region's stockmarkets have risen by $1.6 trillion since 2001, equivalent to one–third of nominal GDP. Residential property prices have picked up. Several economies in the region have already seen their current-account surpluses shrink. Thailand's current account even moved into deficit this year. As these countries are oil importers, high oil prices will also reduce the region's surpluses. Emerging Asia's willingness to send its savings abroad may have peaked. But given the region's recent history, the odds are that the adjustment will be gradual.

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The hare and the tortoise

Sep 22nd 2005
From The Economist print edition

Why have the world's savings gone to America rather than to Europe?

THIS survey has argued that the supply of global saving—relative to desired investment—has grown in recent years, thanks largely to shifts in Asia and in emerging economies. These shifts may help to explain why global interest rates have been low. But they do not explain the geography of current-account deficits. Why has most of this capital been absorbed by America and, to a lesser extent, other Anglo-Saxon economies such as Britain, rather than continental Europe? After all, the euro area's economy is four-fifths the size of America's; its capital markets are liquid; its currency is stable; and its legal protections are as strong as those anywhere in the world.

Yet far from absorbing the rest of the world's capital, the euro area in 2004 ran a small saving surplus ($36 billion) of its own. Whereas America's foreign borrowing has accelerated, especially since 2001, the euro area has remained a lender. Though interest rates are low in both regions, the effect seems to have been very different. Is this evidence of Europe's sclerosis and America's dynamism, or of Europe's prudence and America's profligacy?

One answer is that European aggregates mask big differences between countries. For example, in Spain the economy has been humming and the current-account deficit has soared. Italy has been mired in recession, but thanks to its ageing population its household saving rate has plummeted and its current account is in deficit. At the other extreme, Germany has become a large exporter of savings.

More broadly, though, Europe's thriftiness, relative to America's, results from a mixture of demographics, structural rigidities, policymakers who don't much believe in Keynes and financial systems that are less consumption-friendly.

Twenty years ago, saving patterns in America and Europe were not all that different. In the mid-1980s, American households saved, on a net basis, around 9% of their disposable income. The British figure was 7%, the Spanish 8%, the French 9% and the German 12%. Despite big statistical problems in comparing household saving rates, the ranking is probably about right.

In the 1980s and 1990s, household saving rates fell both in Anglo-Saxon economies and (to a lesser extent) in many continental European ones. Germany saw only a small decline; Italy, with its burgeoning number of pensioners, the largest. But the drop in household saving in America was far bigger than in most of Europe, for two reasons: bigger capital gains and more financial innovation.

Thanks to the long bull market in stocks, particularly after the productivity boom of the mid-1990s, Americans felt richer. A study by Annamaria Lusardi, Jonathan Skinner and Steven Venti of Dartmouth College found that capital gains explain most of the total decline in America's personal saving since the late 1980s. Thanks to a more sophisticated financial system than, say, Germany's bank-dominated arrangements, Americans could also borrow money more easily. Financial innovation has made a huge difference to Americans' access to credit in the past 20 years. Today there are over 1.3 billion credit cards in America, or more than 11 per household.

But whereas household saving rates in the two regions diverged, government saving kept overall national saving rates closer than they would otherwise have been, at least during much of the 1990s. Public finances improved on both sides of the Atlantic, but by more in America. As a result, in 2000, America's overall national saving rate, at 18% of GDP, was not far below the European average of 21% of GDP.

Since 2000, however, the gap has grown much larger. After the stockmarket bubble burst, corporate investment fell on both sides of the Atlantic. That sent Europe's big economies into a trough from which they have not really emerged, whereas in America growth was underpinned by more government and household spending. America's drop in household saving has accelerated, whereas European households, on average, have become slightly thriftier.

Americans now save less than 1% of their disposable income, compared with a euro-area average of 10%. America's budget moved sharply into deficit, whereas Europe's public finances have seen less change. As a result, America's national saving rate is now below 14% of GDP, compared with over 20% for the euro zone.

Old Europe's troubles

One important reason is demographics. “Old Europe” may not like the label, but in the demographic sense it is accurate. Europeans have fewer children than Americans and they allow much less immigration, so European societies are ageing much faster. Relative to America, this reduces Europe's allure as an investment destination and increases its citizens' desire to save.

An analysis in 2000 by PricewaterhouseCoopers, an accounting firm, suggests that demographic changes alone will push up continental Europe's private-sector saving rates by 2-3% of GDP between 1995 and 2015. There is some evidence that the impact of demographics on saving has accelerated recently.

But demography is not quite destiny. Economic reforms could do a lot to make “old Europe” a more attractive place for investment, offsetting the effect of ageing societies. With an average unemployment rate of 9%, the euro area has plenty of spare workers.

Europe has, in fact, made significant progress on economic reform in recent years. Germany's labour market has become more flexible and the country's social benefits have been trimmed. France's pension system has been overhauled. The trouble is that the reforms will take time to translate into economic growth. In the meantime they are making things worse. People save more because they are worried about the future. In Germany, in particular, there is evidence that the uncertainty created by economic reform has boosted the household saving rate. The more people save, the less they spend. The lack of consumer demand, in turn, reduces the incentive for firms to invest.

Yet continental Europe, by and large, has provided far less macroeconomic stimulus than America. Although the euro area's overall budget position went from a surplus of 0.1% of GDP in 2000 to a deficit of 2.7% of GDP in 2004, almost all of this deterioration was due to economic weakness rather than deliberate loosening of the fiscal reins. Allowing for the automatic deterioration in the budget that comes from a slowing economy, the euro area saw no change in its fiscal stance at all, compared with a structural loosening worth 5.5% of GDP in America and 4.5% of GDP in Britain.

So why did Europe hold back? Respect for rules is one reason. The Stability and Growth Pact, which in theory limits the size of euro members' deficits to 3% of GDP, has been severely weakened, but it still restricts the euro-zone governments' room to run big deficits. More important, European policymakers tend to regard fiscal expansions as reckless and ineffective.

That is partly because their long-term fiscal outlook is so dire. Thanks to their generous social safety nets and rapidly ageing populations, Europe's governments face a bigger debt problem than America's, and because their tax rates are already high, this will be trickier to resolve. Italy is in the worst shape: its government already owes the equivalent of 120% of GDP. France's debt ratio is 73%, Germany's 70%. According to projections by the European Commission, by 2030 Germany's debt will more than double, to 157% of GDP, thanks to demographics alone.

In America, in contrast, the underlying fiscal position—prior to the recent loosening— was much more favourable. In 2000, the bean-counters in Congress were predicting budget surpluses as far as the eye could see. America, in other words, had much more room to be Keynesian.

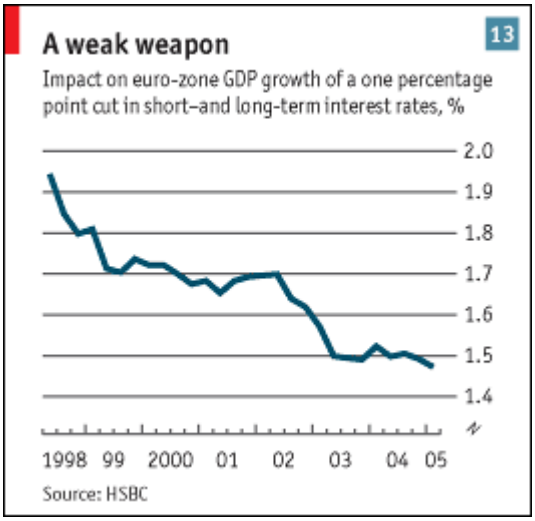
Some European economists claim that fiscal policy is ineffective on their home ground. They argue that European households are more “Ricardian” than Americans, tending to make up for bigger government deficits by saving more themselves. In a study of saving patterns in the 1990s, the OECD concluded that fiscal shifts had a greater effect on private saving in Europe than in America. When budget deficits fell, as they did in the late 1990s, so, too, did private saving, although not at the same rate. Thus, Europeans argue, even if they had taken the Anglo-Saxon route, they might not have got much out of it.

Money isn't everything

If the reluctance to use fiscal stimulus is understandable, the effect of monetary policy is more puzzling. Initially, the European Central Bank (ECB) cut short-term interest rates more slowly and reluctantly than did the Federal Reserve. Now, thanks both to the ECB's rate cuts and the global surfeit of saving, European interest rates are at record lows. Yet the effect on spending has been much less dramatic in Europe than in America, and seems to have been getting weaker. Calculations by economists at HSBC, for instance, show that the stimulus to output from a 1% cut in short- and long-term interest rates rates has been falling steadily (see chart 13).

European monetary union is one reason. The single currency has had the effect of translating the same low nominal rates into different real, ie, inflation-adjusted,

interest rates in different countries. Where inflation is lower than average, as in Germany, real interest rates are higher and monetary conditions therefore tighter.



A more important reason for the relative ineffectiveness of monetary policy in Europe compared with America has to do with the interaction of interest rates, house prices and consumption. In America, lower interest rates fuelled a house-price boom. Flexible mortgages allowed consumers to tap some of their housing wealth. Rising house prices boosted consumption more than higher share prices did in the 1990s, partly because far more people own houses than shares, partly because Americans regarded house-price gains as more permanent than similar gains in share prices.

Germany is at the other extreme. Lower interest rates failed to translate into higher house prices, and even if they had done so, the effect would have been much smaller because far fewer people own their own homes, and restrictive mortgage contracts make it much harder for consumers to refinance their loans at a lower rate.

The rest of the euro area lies in-between. Spain, for instance, looks similar to America. House prices have soared, consumption has boomed and the country is running a large current-account deficit. France has seen house price appreciation, but less of that has been translated into consumption, and the current-account deficit is smaller than Spain's.

In sum, continental Europe had weaker policy levers with which to respond to a drop in investment demand, and it used those levers more reluctantly. As a result, it has been caught in a low-growth, high-saving equilibrium, at least compared with America. An optimist might argue that the euro area has avoided the excesses of America's profligacy while gradually hammering away at its own structural rigidities. If that is correct, today's stagnation should eventually give way to faster growth—and a smaller saving surplus.

There is some evidence to support this view, particularly in Germany. Although that country's economy is still looking weak, with output flat in the second quarter, there have recently been signs that it could be poised for an upturn. After several years of cost-cutting and financial restructuring, German firms have become leaner and more profitable. Unemployment has been falling slightly, although from a high level, and indicators of business optimism have been rising. If Germany were to turn, the whole region would start to look much more cheerful.

But the failure of the German election on September 18th to produce a clear-cut result has dampened any optimism about that country. A government without a strong popular mandate will find it much more difficult to continue with those much-needed economic reforms. So the more pessimistic, and probably realistic, view is that Europe is doubly vulnerable. Germany is still addicted to foreign demand. Some countries, such as Spain, have become reliant on rises in house prices. Italy remains stagnant. And the lack of growth in Europe is taking an increasing political toll.

Within recent months, the French and Dutch voted “no” on the European constitution, plunging the European Union into a bout of self-doubt. Italy's prime minister, Silvio Berlusconi, has called the euro “a disaster”, and several of his cabinet members have suggested that Italy should leave. None of this inspires confidence that continental Europe will do much to rebalance the world economy in the near future, or that countries with surplus saving will rush to invest their money in euros.

Forever free

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Can America go on borrowing abroad indefinitely?

"IF SOMETHING is unsustainable, it will stop." This phrase, coined long ago by Herb Stein, an economic adviser to Richard Nixon, has become a staple of the debate on America's current-account deficit. Officials at the Federal Reserve began to fret about America's "unsustainable" imbalances in 1997, when the deficit was less than 3% of GDP. There was much hand-wringing in 2003 when the deficit passed 5% of GDP, a widely accepted indicator of things going seriously awry. Today, the deficit stands at more than $700 billion, well over 6% of GDP, and is set to rise further. The world is still going round. Is it time to stop worrying about the sustainability of America's foreign borrowing?

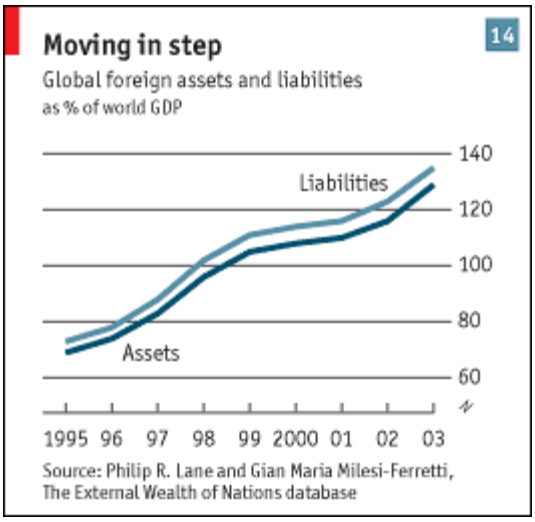
High time, argues a growing band of optimists, most of them American. They offer a variety of reasons. First, they believe that the current-account imbalance is a sign of American strength not weakness: it is caused by foreigners rushing in to share in the proceeds of the country's highly productive and efficient economy. Second, they dismiss the current-account deficit as insignificant in relation to America's total wealth. Who cares about borrowing an annual $700 billion from abroad when American households are worth more than $30 trillion?

Some of these arguments are plainly wrong-headed. If foreigners were keen to share in the gains of American productivity, they would be investing in American shares and factories. That is what happened in the late 1990s. But since 2000, growth in net foreign investment in American shares as well as foreign direct investment in America has slowed sharply. The growing surplus of saving abroad is mainly flowing into American bonds, especially government bonds. Foreigners are lending America money to consume.

The comparison with household wealth is misleading. Most of the recent rise in America's household wealth has come from house prices, and if there is indeed a bubble in the housing market, some of this wealth will turn out to be illusory. Even if the gains are real, they cannot easily be turned into income with which to service America's external debt. Eventually, America will need to export more than it imports to pay its external creditors.

Still, the growth in global capital flows does call for some rethinking about America's current-account deficits. Both foreign assets and foreign liabilities have mushroomed as people across the globe have invested in each other's economies on an unprecedented scale. Gian Maria Milesi-Ferretti of the IMF and Philip Lane of Trinity College, Dublin, have built the world's best database of foreign assets and liabilities in over 120 countries, accounting for more than 99% of world GDP. They found that the stock of all foreign assets owned by these countries was worth the equivalent of 130% of world GDP at the end of 2003, double its level in 1995. The figures for foreign liabilities move roughly in parallel with the ones for assets (see chart 14).

A bigger pool



This rise in cross-border portfolios has had several effects. First, it means that net saving surpluses or deficits are now the balance of much larger gross flows. Given that the pool of internationally mobile capital is much bigger than it used to be, individual countries might be able to run larger imbalances for longer than they used to. According to Messrs Milesi-Ferretti and Lane, America's foreign liabilities as a share of foreigners' overall holdings of foreign assets have fallen in recent years, thanks mainly to a drop in the dollar. In 1999, America accounted for 34% of the rest of the world's foreign-asset holdings. By 2003, that share had fallen to 27%. This does not seem excessive: it is below America's share of the global economy.

Second, the greater volume of cross-border investment means that market fluctuations in the value of a country's gross assets and liabilities can have a bigger effect than new debt. Even if a country is borrowing 6% of GDP a year, the new borrowing can be dwarfed by changes in the value of its stock of cross-border assets and liabilities.

That is exactly what has happened in America recently. At the end of 2003, America's net external debt position—the difference between the value of America's foreign assets and its foreign liabilities—was $2.4 trillion, or the equivalent of 22% of GDP. In 2004, America ran a current-account deficit of almost 6% of GDP, suggesting that the debt stock at the end of the year should have risen to 28% of GDP. In fact, it rose by only $170 billion, or less than 2% of GDP, because valuation gains in America's overall portfolio of foreign assets and liabilities offset much of the current-account deficit.

Why did American investments abroad perform so much better than foreign investments in America? The main reason is the dollar. It is the world's reserve currency, and America—unlike many other debtors—can issue bonds in its own currency. Virtually all America's foreign liabilities are denominated in dollars, whereas around 70% of its foreign assets are in foreign currencies.

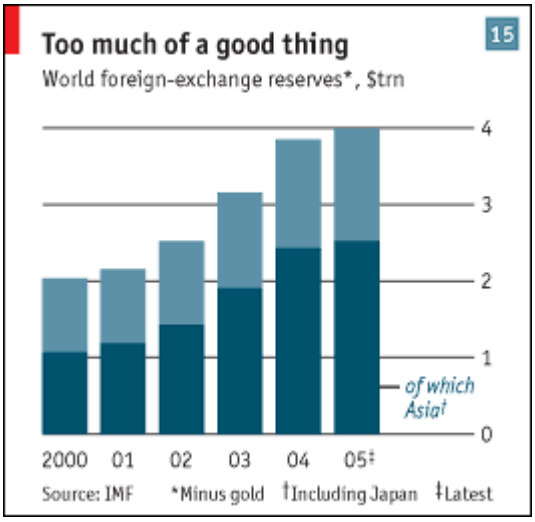
Most of America's foreign assets are in Europe, so when the dollar falls against the euro and sterling, as it did in 2004, America's balance sheet strengthens as the value of its debt falls and the dollar value of its assets rises. According to Pierre-Olivier Gourinchas, an economist at Berkeley, and Helene Rey, of Princeton, this valuation effect is worth about 5% of GDP for every 10% drop in the dollar. That suggests the shift in America's current-account balance needed to stabilise the country's debt profile may be smaller than many people seem to think.

There is a catch, however. At some point, foreign lenders should be demanding higher interest rates to make up for the risk of the dollar falling. According to Messrs Milesi-Ferretti and Lane, foreigners have suffered negative returns on their investments for the past four years. Why have they not balked yet? One reason is the thrift shift that this survey has described. Thanks to a highly unusual constellation of circumstances, surplus saving in the world outside America has risen in recent years.

Trust central bankers?

But that is not all. A second reason for unusually low interest rates is that a large chunk of those surplus savings has been under the control of central banks, particularly in Asia. Thus far, these banks have cared less about risk-adjusted returns than about stopping their currencies from rising. The sustainability of America's deficit and the risk of a hard landing depends on whether they will continue to do so.

Central banks have been amassing foreign-exchange reserves on a huge scale. The world's central banks have increased their foreign-exchange reserves by some $2 trillion since 2000, three-quarters of it in Asia. As chart 15 shows, this reserve accumulation is still continuing apace.



Exactly what share of these reserves flowed into American assets is a matter of whose statistics you look at. Official American figures show that central banks bought $280 billion of American assets in 2003 and $395 billion in 2004, or around 50% of all American bonds bought by foreigners in those years. But these numbers exclude any bonds that central banks buy in secondary markets abroad, so they surely underestimate the total. The BIS reckons that central banks bought $440 billion-worth of dollar assets in 2003. The official numbers for 2004 are not out yet, but the BIS total is likely to be similar.

Whichever numbers you choose, central banks' increases in dollar reserves have been large compared with overall foreign purchases of American bonds, and huge compared with the size of the current-account deficit. Although central banks hold a small share of the stock of America's external liabilities, they have become big marginal buyers. In 2003, they financed the equivalent of 50% of the current-account deficit according to American numbers and 80% according to the BIS. In 2004, the level was 60-70%.

This explains the popular argument that the yield on America's Treasury bonds is determined in Beijing and that America is locked in a “balance of financial terror” with communist China. Estimates of the effect of Asian reserve accumulation on America's interest rates differ wildly. Economists at Goldman Sachs reckon it is worth around 0.4 percentage points; research at the Federal Reserve suggests it could be between 0.5 and 1 percentage points. At the other extreme, Nouriel Roubini and Brad Setser, of Roubini Global Economics, think that American interest rates could rise by up to 2 percentage points if Asian central banks stopped their intervention.

But is that likely? Those in the gloomy camp, epitomised by Messrs Roubini and Setser, put forward several reasons why it will happen sooner rather than later. First, they argue that China is finding itself increasingly alone as a buyer of dollars as other central banks grow wary of a currency that must at some point depreciate. Second, China will have to stop buying because the losses it will face when the dollar eventually falls will be prohibitive (perhaps over 20% of China's GDP by 2008, according to one calculation). Third, large-scale currency intervention will eventually cause inflation in China to rise, forcing a change in policy.

So far, this has not happened. Although the pace of reserve accumulation in China has increased this year, there is no sign of rising inflation. The country has made a first move towards changing its exchange-rate regime, which might eventually imply fewer reserves overall as well as some diversification away from dollar reserves, but nothing suggests that it is in any hurry. And the pessimists probably put too much weight on the “irrationality” of China accumulating reserves on which it will eventually incur losses. China's government appears to worry much less about such losses than about stability in the domestic economy. No doubt its politicians will eventually wean

the economy off its heavy reliance on the debt-laden American consumers, but not overnight.

For the past few years, central banks have been acting as cushions. When private investors have little appetite for American assets, as in 2003 and 2004, central banks buy a lot in order to stop their currencies from appreciating too much against the dollar. When private appetite rises, central banks buy fewer. That is what seems to have been happening this year. Although China has been accumulating reserves at a rapid rate, few of these appear to have been American bonds and short-term Treasury bills. According to Mr Setser, foreign governments may have bought only about $20 billion-worth of those in the first six months of 2005—and yet the dollar strengthened. Even if that understates the real picture, it suggests a sharp drop in central-bank purchases of American bonds compared with 2004.

This survey has argued that Japan, China and the oil states are likely to continue piling up saving surpluses for some time yet. If Asia's central banks also remain willing swing purchasers of the dollar, that may seem cause for relief: it suggests that things will go on much as they are, avoiding a hard landing. But relief would be the wrong reaction. As long as America can get cheap money from abroad, it has little incentive to rebalance its economy. So when those global economic imbalances are eventually unwound, it will hurt that much more.

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The price of privilege

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Too much foreign money is bad for America's economy

WHEN Mr Bernanke launched the discussion about the saving glut, Mr Bush's economic officials enthusiastically embraced his speech. His message that the sources of America's current-account deficit were not “made in the USA” seemed to imply that there was nothing much for America to worry about.

But the truth is that the growing imbalances are weakening America's economy, not only because of the extra foreign debt the country has taken on, but because of the domestic toll of being the world's consumer of last resort. America is saving too little and not investing enough in productive assets, especially in the export sector. Its economic health depends too heavily on housing wealth.

That is partly a cyclical story. Firms spent the period from 2001 to 2003 working off the excesses of the 1990s investment binge. In 2003 industrial capacity shrank in real terms. To some extent, things have improved over the past couple of years. Capital spending has been growing at a healthy 9% a year. Nonetheless, corporate spending as a share of GDP is still well below its average for the past 25 years. Productivity growth has recently slowed, so the lack of investment may be starting to take its toll.

Moreover, this cyclical story conceals a more serious problem. To generate the exports that will eventually be needed to service its foreign debt, America needs to invest a lot more in sectors that produce goods and services that can be sent abroad. Yet exports make up less than 10% of America's economy. Whereas the world's surplus savers—China, Japan, Germany—have too many resources devoted to exports and too few to expenditure at home, America has the opposite problem.

In principle, the global saving glut ought to help by keeping capital cheap. But because the excess saving hails from abroad, it keeps the dollar strong, so low interest rates continue to have a bigger impact on America's property market than on its export sector.

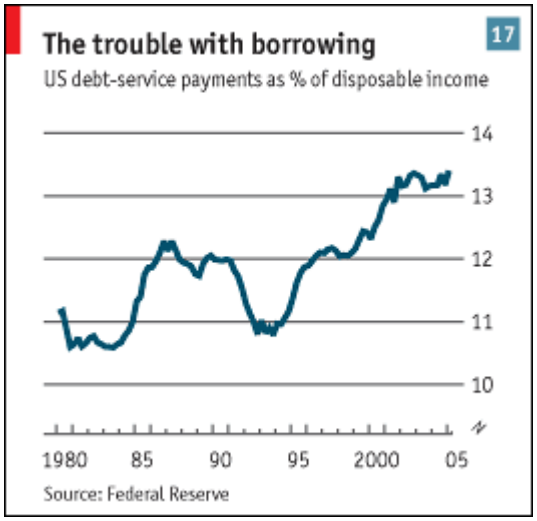
Since 2000, the rise in house prices has accelerated sharply. Average American house prices are increasing by around 13% a year, the fastest rate for 26 years. Signs of speculative excess abound, particularly in the “hottest” markets on the country's east and west coasts. Everyone agrees that the current frenzy cannot continue forever, and even Alan Greenspan now acknowledges that house prices could fall.

Yet gains in house prices have been underpinning America's continuing consumption boom. Over the past four years, consumption and residential investment together accounted for over 90% of the rise in America's GDP. Even more striking, 40% of all new private-sector jobs have been in construction, mortgage-broking and other areas related to housing.

With interest rates low and the equity in their houses easily accessible, Americans have given up saving out of current income altogether. Five years ago they still saved more than 2% of their post-tax earnings; in July this year

the household saving rate was minus 0.6%, the lowest on record (see chart 16). Economic studies show that housing wealth reduces saving by more than other kinds of financial wealth. Nonetheless, the pace of decline has surprised most economists.

Rather than saving, many Americans are borrowing merrily. Even with interest rates historically low, the share of disposable income devoted to debt service is at a record 13.4% (see chart 17). And there is other evidence that consumers are heading for trouble. A rising proportion of new mortgages are interest-only, and are linked to short-term interest rates. Financially stretched borrowers account for a growing share of consumer debt. All this suggests that America's consumers are now less able to cope with financial shocks than they were five years ago.



Lastly, America's public finances have become weaker. Not only has the budget swung sharply from surplus to deficit, but the policies that caused the shift will have far bigger consequences in the future than they have had so far. Thanks to robust growth—and strong corporate profits—tax revenues have been unexpectedly high this year. As a result, the budget deficit looks set to fall below 3% of GDP. But many of the big fiscal decisions on Mr Bush's watch, such as the introduction of a prescription-drug benefit under Medicare, will hurt the government's finances far more in the future. The aftermath of Hurricane Katrina may reduce the chances of fiscal discipline. In sum, America's role as the global consumer of last resort has left it vulnerable. Low interest rates have fuelled a property boom, lulling consumers into thinking that there is no need to save and persuading politicians that it is possible to have both guns and butter.

Some might argue that these weaknesses seem a small price to pay for holding up the world economy in the face of unprecedent thrift shifts. Compared with the mess in much of the rest of the world, the American economy still looks pretty sound. Productivity growth is still faster than in many other parts of the rich world, and corporate investment has picked up more than elsewhere. For all the speculative frenzy in the hottest markets, property in America as a whole is not yet as overvalued as in many other countries.

But the longer America acts as global consumer of last resort, the more dangerous these domestic weaknesses become. The longer the economy concentrates on non-tradables, for instance, the harder it will become to produce the exports that America will soon need. Moreover, the foreign saving glut removes America's incentive, and to some extent its ability, to reduce its domestic

distortions.

Monetary policy has become harder to conduct. Initially, Mr Greenspan's decision to slash short-term interest rates in 2001 and then keep them low meant that American consumers went on spending when American firms did not. But although since June 2004 Mr Greenspan has raised short-term interest rates by well over two percentage points, long-term rates, which matter much more to the mortgage market, are still lower than they were 15 months ago. Thus, despite the central bank's efforts to tighten financial conditions, the housing frenzy continues.

The surplus of saving outside America is not the only reason for this. The lack of concern about future inflation has also played a big part. But there is little doubt that the thrift shift has altered the relationship between short-term and long-term rates and made life harder for America's central bankers. If they keep short-term rates too low for too long, they will add to the excess liquidity in the world economy. If they raise short-term rates too far, too fast, debt-laden consumers will buckle.

Moreover, the abundance of foreign thrift makes it unnecessary for American politicians to tackle their country's own fiscal challenges. America may have better demographics than Europe, but its current spending policies on pensions, and particularly on health care for the old, are clearly unsustainable. Yet when long-term interest rates are low, there is no incentive for change. America's big fiscal improvement in the 1990s owed a great deal to politicians' fear of the bond-market vigilantes.

These days, although Washington's politicians talk a lot about fiscal discipline, they do little about it. In the past few months they have, among other things, doled out vast subsidies to energy producers and promised hundreds of billions of dollars for transport projects. Such profligacy may not matter much when interest rates are so low, but it sets America up for much bigger problems when the saving glut eventually disappears.

Simply carrying on as before also carries a more imminent risk: that America's role as the global consumer of last resort will become unsustainable before the rest of the world works off its saving surplus. One trigger might be petrol prices. Sharp rise in fuel costs, particularly in the wake of Hurricane Katrina, might prompt American consumers to tighten their belts. Another would be a house-price bust. American houses, overall, are less overvalued than those in some other countries, but Americans are more reliant on their housing wealth than others.

There are worrying precedents. In the Netherlands, a slowdown in the rate of property appreciation from 20% a year in 2000 to zero in 2003 sent consumption plummeting and the economy into recession. In Britain and Australia, a mere flattening of house-price rises has slowed consumption sharply. Most American economists reckon that if house-price increases levelled out, consumer-spending growth would lose pace, slowing the economy but not by enough to push it into recession. Yet the giddier the prices become, the greater the risk of a far nastier tumble.

Another trigger could be protectionism. The counterpart to America's foreign borrowing is a rising trade deficit. America's lawmakers are convinced that this trade deficit is the result of “unfair” trade, particularly from China with its “undervalued” currency. That country's shift to a currency basket in July has temporarily lowered the political temperature in Washington, but probably not for long. Legislation that allows America to impose countervailing tariffs in retaliation for China's “subsidised” currency is already making headway in Congress.

Things are likely to get much worse. As China's economy slows and its current-account surplus rises further, the calls for protectionist tariffs and quotas will become louder. Individually, any new tariffs might be no more than irritants, but a broad push in Washington towards more blanket protection cannot be ruled out. That would cause serious disruption.

At the same time, the furore over China's failed bid for Unocal, a mid-sized Californian energy company, showed that American politicians are in two minds about the consequences of a rising Chinese saving surplus. They seem to think it is fine for China to buy Treasury bonds, but not other assets. If there are any more high-profile bids from Chinese firms for American ones, Congress might resort to a flurry of protectionist measures.

These risks are real, and growing. They suggest that, regardless of foreigners' willingness to maintain the status quo, America itself may not be able to cope with current patterns of global thrift for much longer. So what should it do?

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Rebalancing act

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How to tame the thrift shift

IF THE first step towards finding a solution is to agree on the problem, the world's policymakers are still a long way from solving the global imbalances. European politicians blame American profligacy, urging Mr Bush's government to cut its budget deficit. Chinese politicians echo those sentiments.

Yet for American lawmakers on Capitol Hill, there is only one villain: China and its undervalued currency. The analysis in the White House is more sophisticated, but still tends to Mr Bernanke's view that America's current-account deficit is not “made in the USA”.

Moreover, within both the White House and the Federal Reserve, it has become fashionable to argue that a smaller budget deficit would do little to reduce America's external imbalances anyway. American policymakers lapped up a recent study by the Federal Reserve which suggested that a 1% cut in the budget deficit would improve the current-account deficit by only 0.2%. But this is not uncontested: a report by the IMF, for instance, has estimated that an improvement in America's fiscal position of 4% of GDP would cut the external deficit by 2% of GDP.

All of this misses the bigger picture. The current pattern of global imbalances is the result both of thrift shifts abroad and of American actions. Had American saving rates fallen as they did, with no change in foreigners' desire to save and invest, interest rates would have risen. Had foreigners' shift to thrift not been matched by Americans' spending, the world economy would have plunged into recession. With much of the world determined to save more and invest less, America's stimulative fiscal and monetary policies, coupled with its penchant for consumerism, have kept the global economy humming.

But, as this survey has shown, that global growth has come at a price. America's current rate of borrowing is excessive. Despite the advantages of having the world's reserve currency, an enviable rate of productivity growth and the world's most liquid capital markets, America cannot continue to borrow at an accelerating pace forever.

More important, America's easy access to cheap money is pushing its economy in the wrong direction. Most of that foreign money is going into consumption and housing rather than boosting investment in productive American assets. Building houses does not raise long-term economic growth in the way that equipping a factory does. And the current rate of consumption, fuelled by housing wealth, leaves many indebted consumers at risk. The world as a whole may have savings to spare, but many Americans do not.

Unfortunately, there is little sign that anything will change very quickly. If oil prices stay around $60 a barrel, the oil-exporting countries could see current-account surpluses of up to $500 billion in 2006. China's saving surplus is heading higher. Although the saving surpluses in other emerging Asian countries are falling, there is little sign of a broader shift away from foreign thrift, and America's current-account deficit looks set to rise faster still.

Over the medium term, things will change. Japan's current-account surplus could well fall over the next few years—unless its politicians take fiscal consolidation to extremes, or the expected investment recovery proves ephemeral.

Eventually, oil producers will start spending some of their wealth, and China will gradually pay more attention to its domestic economy. Just as American politicians fret about being dependent on communist China, so Chinese officials will grow ever more nervous about relying on American consumers for their growth.

This turnaround could occur quite naturally. As the foreign saving surplus abates, the dollar could fall further, prompting higher interest rates in America, less domestic spending and a greater emphasis on exports. But there is a substantial risk that the decline in foreign thrift will come too slowly. America's consumers could buckle, or its politicians turn protectionist, before the rest of the world is weaned off its addiction to American demand. So it makes sense to nudge the process along.

Start here

What, then, needs to be done? For a start, recognise who has to be involved. Given the size of their saving surpluses, oil-exporting countries should be at the centre of the discussion. Yet they are rarely even invited to G8 summits and other global policy pow-wows. The rich countries have understood the importance of including China in their gatherings. Wen Jiabao, China's prime minister, attended the most recent G8 summit in Scotland. But when politicians are discussing global imbalances, they will have to broaden the guest list further.

More important, their “to do” list needs to be revised. Reducing China's saving surplus is about more than simply calling for a stronger yuan. It means creating the conditions that encourage more efficient investment and reduce the need to save quite so much. That requires more emphasis on corporate and financial reform: creating incentives for firms to pay dividends, and the infrastructure that makes it easier for people to borrow.

It also means persuading China's government to spend more on social safety nets. Although its population is ageing, China's fiscal situation is healthy. It has plenty of scope to spend more. Higher public spending—on hospitals, schools and helping the poor—will itself reduce China's national saving rate, and creating better health, education and pension systems will reduce the

incentive to save so much. Japan's example suggests that there is no particular Asian propensity for thrift. Create social safety nets and develop consumer finance, and saving rates will fall.

Europe, too, would do well to adopt a less hair-shirt attitude towards policy stimulus. The European Central Bank remains too reluctant to cut interest rates. Europe does not need, and cannot afford, a fiscal binge of American proportions, but the recent lesson from Japan is that if economies stagnate, government debts spiral.

If the rest of the world could do with a less puritan take on thrift, America needs to be reminded of its virtues. Even if the Federal Reserve's boffins are correct, and cutting the budget deficit by itself would do little to reduce America's external borrowing, less government borrowing is still the most certain route to higher national saving. A smaller deficit would also reduce the squeeze on ordinary Americans: when the dollar falls, interest rates would need to rise less if the budget deficit was shrinking.

Convincing the American people to save more is trickier. The best-known route—subsidising saving through the tax code—generally does not work. America loses more in tax revenue on its panoply of saving incentives than they generate in new household saving.

Rather than try to boost saving directly, America should reduce the huge subsidies its tax system offers to anyone buying a house, which along with low interest rates have helped to fuel Americans' recent love affair with property. Mortgage-interest payments are tax-deductible, and capital gains up to $500,000 on a house sale are tax-free. Putting an end to both these subsidies, or at least sharply reducing them, would help to encourage more investment in productive assets.

These policies will not reverse the shifts in global saving and investment entirely. Nor should they. There are plenty of reasons for America to carry on borrowing from abroad. It has better demographic prospects than the rest of the rich world, and indeed than many Asian emerging markets. It has nimble and productive firms. Once investment has shifted back into productive assets, America might sustainably run a current-account deficit of, say, 3-4% of GDP for many years yet.

But the present deficit is excessive and dangerous. Left alone, it could end in a global recession, rampant protectionism, and even a disastrous financial crash. That is why policymakers need to act soon. With his “saving glut” speech, Mr Bernanke focused attention on the scale of the global thrift shift. Now, as one of Mr Bush's top economic advisers, he should persuade his boss of the importance of making the thrift shift safe.

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All figures for national saving and investment are drawn from the September 2005 World Economic Outlook and are aggregated using market exchange rates. Where possible, OECD data is used for household saving.

General sources include Bank for International Settlements, Annual Report, (various issues); World Economic Outlook, IMF (various issues, especially September 2005); OECD Economic Outlook (various issues).

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Business and the internet

Bubble 2.0

Sep 22nd 2005 | NEW YORK
From The Economist print edition

A spate of expensive internet deals is creating a sense of déjà vu

NASTY memories have been stirred up by this week's reports that Microsoft is in talks to buy a big stake in America Online. After all, the last time that AOL was involved in a big deal—its $150 billion acquisition of Time Warner, a media giant, in January 2000—it soon came to symbolise the madness of internet-company valuations, during the turn-of-the-century dotcom bubble. Nobody expects Microsoft to repeat the near-suicidal folly of Time Warner. But if there is any truth to market rumours that its purchase will value AOL—now a shadow of its old self—at over $20 billion, or about $1,000 per AOL subscriber, then the deal would certainly fuel fears that irrational exuberance is returning to the pricing of internet-related firms.

A Microsoft stake in AOL—which it would merge with its MSN portal—would come hot on the heels of last week's purchase of Skype, an internet-phone company, by eBay, an internet-auction site. There is no doubt that there is huge commercial potential in internet telephony. But how that potential will come to fruition—and whether Skype will be the company that benefits—are very much open questions. Look at the raw numbers, and this seems like a deal with strikingly bubble-era economics: a price of at least $2.6 billion for a loss-making firm with unlimited ambition but expected revenues this year of only $60m.

Such a high price is hardly unique. Among other richly priced deals contributing recently to the bubbly mood are Barry Diller's IAC/InterActive's $1.9 billion acquisition of Ask Jeeves, a search engine, in July; News Corporation's purchase of IGN, a video-gaming site, this month, and Intermix Media, a social networking site in July, for a combined $1.2 billion; and Yahoo!'s $1 billion purchase in August of a stake in Alibaba.com, a Chinese internet site that actually prides itself on its lack of a clear business model. Speculation that they will be gobbled up next has lifted

shares in several other internet firms, including The Knot (an online wedding planner) and CNET Networks, a news site—both up by over 50% in the past six months.

“The Skype deal is absolutely a return to the 1999 mentality,” says Pip Coburn of Coburn Ventures, a technology-strategy firm. It and many of the other recent and mooted internet deals seem to be based on little more than the belief of management that everything is going to change dramatically in the next few years, in highly unpredictable ways, and so all options need to be covered. Given that mentality, says Mr Coburn, a manager “can pretty much justify paying any price”.

Valuing a firm is tricky at the best of times (as is making a success of a merger), but it is especially hard for a young firm. The rationale of Rajiv Dutta, eBay's chief financial officer, for the firm's valuation of Skype does little to inspire confidence. He first compared Skype with eBay's previous biggest acquisition, of PayPal, an online payment system that is not obviously comparable to a phone service (and which, unlike Skype, eBay knew intimately before the acquisition). PayPal cost 8% of eBay's market capitalisation in October 2002, said Mr Dutta, whereas Skype cost only 4.8% of eBay's current market cap. But is that the right measure? Skype's revenue growth in the 12 months in which it has charged for some of its services, he noted, was faster than eBay's at a similar stage in its development. Again, why is this relevant? Skype and eBay have completely different business models. Finally, its current losses notwithstanding, Mr Dutta thinks that Skype will have a long-term operating-profit margin of 20-25%—apparently for no other reason than that eBay also assumed that PayPal would achieve that same margin.

While Skype and eBay may yet develop lucrative synergies, the deal does not impress Hal Varian, an economist at Berkeley and co-author of an influential book, “Information Rules: A Strategic Guide to the Network Economy”. Skype's technology is not hard to replicate, and internet telephony is becoming highly competitive, he says. Skype's founders, Niklas Zennstrom and Janus Friis, were smart to take the money—just as earlier AOL's then boss, Steve Case, was wise to exchange AOL's hugely overvalued shares for Time Warner's undervalued old-economy assets.

Déjà vu or not, even the greatest pessimists do not think that history is simply repeating itself. Share prices today are nothing like as crazy as they were in 2000, at least in America. (To relive the full dotcom bubble experience, try China instead, where America's erstwhile “internet queen”, Mary Meeker of Morgan Stanley, has just been anointing her local favourites.) American investors no longer have much appetite for initial public offerings of shares in firms with nothing more than a bright idea and half a business plan. The price-earnings (p/e) ratios of shares in some of the best-known internet firms are certainly sky high—Google's is 90, and eBay's is 54, compared with a p/e of 18 for the Dow Jones average. They need to boost profits spectacularly to justify these prices; but at least nowadays there are lots of earnings to include in the p/e ratio.

Google is so highly priced in large part because of its mastery of one of the few truly profitable internet business-models: the sale of effective online advertising. But its striking success is alerting rivals to the dangers that Google and other peddlers of online advertising pose to their businesses—which is prompting them to explore how to fight back, which in turn could hurt the now thriving firm's profits, and expose any overvaluation.

Newspaper, television and radio companies, for instance, have all recently started to understand the threat posed to their traditional advertising revenues by online advertising. A speech by Rupert Murdoch earlier this year on the need for media firms to embrace the internet showed that the industry is not willing to give in easily to its new enemy. The traditional telecoms and cable companies have also started to wake up to the potentially massive threat posed to their revenues by cut-price internet telephony of the sort offered by Skype. They, too, are looking for ways to fight back.

As these industries and firms collide, it is far from clear which firms will emerge on top, and how profitable they will be. That makes valuing their shares extremely hazardous. In January 1999, asked to sort out the hype from the fundamentals in internet shares, Alan Greenspan, the chairman of the Federal Reserve, compared owning shares with buying a lottery ticket. Each share had a small chance of securing a great reward, but a high probability of failure. “What lottery managers have known for centuries is that you could get somebody to pay for a one-in-a-million shot more than the value of that chance,” observed Mr Greenspan. Hence, the more volatile the business outlook, the more likely “you will get a lottery premium in the stock”.

One difference between today and the late 1990s is that today many of the fancy prices of internet firms are being paid by companies buying them, rather than by investors merely buying their shares. Their motives are understandable: to protect themselves from the potential risks and position themselves for the potential rewards of a maturing internet. What remains to be seen is how much some of these embattled firms will pay in their pursuit of the winning lottery ticket.

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Economist.com BUSINESS

The gambling industry

The wheel of fortune

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America's booming casinos

CLEARLY you should never bet against Mother Nature—witness the cost of Hurricane Katrina to America's gambling industry: a string of casinos along Mississippi's Gulf coast in ruins and 14,000 employees out of work. So why is the American Gaming Association (AGA), which celebrated its tenth anniversary last week in the hurricane-proof glitter of Las Vegas, so upbeat?

The answer is that an industry which used to be a by-word for racketeering has cleaned up its act and is more profitable than ever. Today it is run by quoted corporations instead of the Mob and is confident of winning public acceptance.

Last year some 54.1m people—more than a quarter of American adults—visited a casino, on average six times each. Poker is a particular growth area. Some 18% of American adults played poker last year, a 50% increase over the previous year. Together, the country's 445 commercial casinos (a definition excluding casinos owned by Indian tribes) had revenues of nearly $29 billion and paid state gaming taxes of $4.74 billion, almost 10% more than in 2003. A survey of 201 elected officials and civic leaders (not including any from gambling-dependent Nevada and New Jersey) found that 79% believed casinos had had a positive impact on their communities.

But could the industry's lucky streak run out? The AGA's president, Frank Fahrenkopf, a former chairman of the Republican Party, points to two potential problems: fears of the social impact of gambling—especially crime and addiction (quaintly termed “disordered gambling”)—and increased tax rates.

Not surprisingly, the AGA pooh-poohs the notion that the social costs of gambling outweigh its benefits in providing amusement, employment and taxable revenue. It points to the National Gambling Impact Study Commission, which in 1999 concluded that a mere 0.6% of America's adult population had serious problems with gambling. Maybe so, but Focus on the Family, a leading conservative organisation, counters that the gambling industry managed to get three members of the Nevada casino industry and one representative of Indian gambling interests on to the nine-member commission—and, even so, the commission concluded that “pathological gambling is found proportionately more often among the young, less educated, and poor”.

On tax, the industry argues that states that levy a lower tax on gambling actually receive larger tax revenues—and a comparison between low-tax Nevada and New Jersey, and high-tax New York seems to support the argument. But emotion also comes into play—“sin taxes” are popular. Mr Fahrenkopf complains that the media “in this country is vehemently anti-gaming, even in this town [Las Vegas]”.

Looking ahead, however, the odds are surely with the industry. A more welcoming regulatory climate and the huge potential of internet gambling signal higher profits ahead. As one American comic once put it: “Betting is pretty much like liquor: you can make it illegal but you cannot make it unpopular.”

Hybrid cars

Battery assault

Sep 22nd 2005 | TOKYO
From The Economist print edition

How Toyota has seized the initiative

IT IS going awfully fast, and they are not sure where it is leading them, but Toyota's rivals reckon they have no choice but to give chase. The Japanese carmaker is so pleased with the success of its Prius, an electric-and-petrol hybrid car that has sold well in America, that it is pressing ahead with plans to put hybrid engines in a range of other cars and sport-utility vehicles (SUVs). Next week Toyota will launch a new advertising campaign in which it will spend up to $60m trumpeting its hybrid technology. Competitors, ranging from America's General Motors to Germany's BMW and DaimlerChrysler, are scrambling to roll out hybrids of their own. On September 21st Ford announced that it could increase production of hybrid cars tenfold by 2010.

Adding a hybrid engine costs thousands of dollars, which puts off many consumers. But Toyota is pressing ahead anyway, confident that, with practice, it can master fuel-saving technologies more quickly than rivals. Since it launched the new Prius in America in 2003, Toyota has sold over 150,000. It can probably sell many more hybrids, now that it has begun putting such engines into its other models.

The Prius, after all, is an odd-looking machine. Its owners are either so green, or so keen to pinch their petrol pennies, that they were willing to buy an ugly car to prove it. By contrast, some buyers who would never go near a Prius may choose an existing SUV or luxury car over a rival model if it comes with a fuel-saving and eco-friendly hybrid option that is partly subsidised by the maker. Toyota began offering hybrid versions of its Highlander and Lexus SUVs earlier this year. Although Americans love their oversized SUVs, they are heavy machines that guzzle petrol. So buying a hybrid version might ease some of the guilt, even if the savings at the pump do not end up offsetting the higher price.

Toyota will also put a hybrid engine into one of its Lexus luxury sedans, and Honda will do the same for its Acura. That will give wealthy greens a chance to tout their eco-friendly credentials without sacrificing style. Selling hybrid sedans to middle-class consumers might be trickier, but the Japanese are going to try. Honda has just launched a new hybrid version of its popular Civic in America, and Toyota will begin selling hybrid versions of its Camry sedan in 2007. Overall, Toyota is racing towards its target of selling 1m hybrid vehicles worldwide by 2010.

That is the last thing that its American, European and Korean rivals want to hear. Many of their executives complain that hybrids are unprofitable and overhyped. Those rivals are upset with Toyota, for setting the agenda so deftly; with themselves, for failing to keep pace; and with consumers, for having the temerity to buy what they do not want to sell. The European carmakers have trumpeted diesel technology as a fuel-efficient and eco-friendly alternative. Toyota also sees merit in diesels—it opened a new diesel-engine plant in Poland last week—but it has no intention of making life easy for its rivals by taking its foot off the hybrid accelerator.

So everyone else is now playing catch-up. General Motors is teaming up with DaimlerChrysler and BMW on hybrid technology, and will launch hybrid-equipped SUVs in 2007. Volkswagen is co-

operating with Porsche. Ford is ramping up production. Toyota may leave them in the dust anyway. While its rivals struggle to integrate hybrid engines into their vehicles, the Japanese giant hopes soon to cut the extra costs of those engines in half.

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Alternative fuels

A tankful of sugar

Sep 22nd 2005 | HORTOLÂNDIA AND SÃO PAULO
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Has Brazil found the answer to high petrol prices?

WHILE motorists elsewhere fret about high fuel prices, new-car buyers in Brazil can feel smug. They can fill up with petrol, ethanol (alcohol) or any combination of the two. And right now, ethanol is up to 55% cheaper at the pump in Brazil than regular gasoline.

Brazilians are the beneficiaries of an automotive revolution: “flex-fuel” cars that run as readily on ethanol as on regular petrol were introduced in 2003, and have since grabbed nearly two-thirds of the market. In America some 4.5m vehicles can run on blends of up to 85% ethanol, but that fuel is available only in Minnesota. In Brazil ethanol is everywhere, thanks to a 30-year-old policy of promoting fuel derived from home-grown sugar cane.

Eager for energy independence or lower emissions of greenhouse gases, other countries are now starting to promote “bio-fuels”. But America and Europe favour their own farmers, who produce fuel based on corn or rape-seed that is mainly used as an additive to conventional petrol—and is dirtier and more expensive than Brazil's sugar-based ethanol. So bio-fuelled cars may take years to catch on in other markets.

For Brazil, this is a second try at a failed romance. Prompted by the oil shocks of the 1970s, Brazilian governments used laws and subsidies to promote ethanol-only cars, which had 90% of the market by the late 1980s. But supplies of sugar-based fuel dried up suddenly when planters rushed to meet a surge in demand for sugar. Sales of ethanol-powered cars dropped to nearly zero by 1990—one taxi driver famously set his alight outside Congress.

Flex-fuel cars have persuaded Brazilians to give ethanol a second try. The initiative came from the Brazilian operations of parts suppliers such as Magneti Marelli, owned by Fiat of Italy, and Bosch, a German company. They persuaded the government to extend to flex-fuel cars the tax break previously applied to ethanol-only models. Volkswagen was first to the market, followed quickly by other big manufacturers.

The Brazilian car industry as a whole is struggling. Might exports of flex-fuel cars prove its salvation? Probably not, alas. If the cars become popular outside Brazil, they could easily be made elsewhere. Brazilian parts suppliers are more likely to benefit than car makers. Bosch has sold fuel-supply systems for America's fleet of superfluous flex-fuel cars. Magneti Marelli would probably start by exporting components, but with higher volumes would move towards selling the technology. Brazil's biggest opportunity may be to sell fuel rather than flexibility. Its cost of sugar production is so low that ethanol can compete with petrol even with oil prices at $35 a barrel, about half of today's price.

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Economist.com BUSINESS

Stem cells and business

Hype over experience

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From The Economist print edition

The commercial potential of stem cells

Get article background

MEDICAL discoveries often excite great hopes—and stem cells are no exception. They can transform themselves into other types of tissue, such as skin or nerve cells. This opens the possibility that they might be used to repair damage done by disease. As a result, stem cells have been credited with almost miraculous healing potential, offering the possibility of treating disorders from diabetes to damaged spinal cords.

With such great medical promise come grand financial predictions. Some analysts have forecast a $10 billion market for stem-cell technologies by 2010. But not Michael Steiner and Nils Behnke, consultants with Bain & Company. They have taken a close look at the state of the science, regulation and commercial environment surrounding stem cells and come up with a far more modest (and convincing) forecast of $100m for stem-cell therapies by the end of this decade, possibly rising to $2 billion by 2015.

According to Bain's estimates, there are now roughly 140 stem-cell-related products in development, for various forms of cancer, liver disease and other conditions. But more than four-fifths of these projects are in early-stage development, where many a gleam in a scientist's eye dies, and still far from the clinical studies where promising new treatments can also still falter. In addition to these scientific hurdles, the field is fraught with ethical debate over some of its most promising areas, such as the use of stem cells from embryos and therapeutic cloning.

This controversy has translated into restrictive regulations in many parts of Europe. While some American states, notably California, have pressed ahead with stem-cell research, the federal government maintains a tight policy on embryonic stem cells—which have more therapeutic potential, but which are also more controversial because they are often associated with abortion or cloning. Since it is the federal government which has the biggest pot of research money, many scientists are frustrated by the pace of development.

All eyes are now on the United States Congress, which is due to consider changes to current stem-cell legislation, possibly lifting some of its restrictions later this year. Meanwhile new centres of biomedical research, such as South Korea and Singapore, are pressing ahead with stem cells, leaving many others behind.

All these risks are putting a damper on funding. Mr Steiner reckons that just over $1 billion was spent on stem-cell work last year, a mere 1% of global spending on health-care R&D. More than four-fifths of that investment came from governments. Venture capital, the traditional engine of biotechnology, is remarkably scarce in stem cells. Only $50m was pumped into the field last year, as private investors look for safer bets in more developed products with larger markets, where regulation and patent protection is more clearly defined. It will be some time yet before the reality of stem cells catches up with the rhetoric.

Economist.com BUSINESS

Rupert Murdoch in China

The end of the affair

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News Corp discovers that China can treat its friends as badly as its enemies

Reuters

FIERCELY independent media mogul and defender of democracy everywhere—that was the Rupert Murdoch on display at a Bill Clinton-organised conference in New York on September 16th. The News Corporation chairman castigated Yahoo! for leading Chinese authorities to the identity of a local dissident journalist, subsequently jailed for ten years. He excoriated Beijing's policymakers as “paranoid” for reversing an opening of the mainland media market. And he admitted that his own business in China had “hit a brick wall”. In August, News Corporation's Star TV had its innovative joint-venture with Qinghai Satellite, a regional broadcaster, cancelled; and since July, it has been investigated for illegally selling decoders to forbidden News Corp channels.

It all sounds like 1993, when Mr Murdoch, who had just bought Star, declared that satellite TV posed an “unambiguous threat to totalitarian regimes everywhere”. Since then, however, Mr Murdoch has whistled a different tune. To appease a Chinese leadership infuriated by his comments—and tap the mainland media market—he performed a series of abject kowtows. The objectionable BBC was dropped from Star's north Asian schedule. Harper Collins, News Corp's publishing arm, dropped a book by Chris Patten, Hong Kong's last governor, and a man detested by the Chinese government.

Instead, Star set up a joint-venture, Phoenix satellite TV, with Liu Changle, an ex-army officer in charge of military broadcasts—and gave CCTV, the mainland's national broadcaster, a stake. The Chinese government initially turned a blind eye to the fact that the hugely popular Phoenix was being illegally aired on black-market satellite dishes all over the country—and even to its reporting politically sensitive news—because its slick coverage of state affairs made China's leaders look good. Phoenix was publicly praised by party leaders; a warning to the lumbering CCTV.

The Star venture also led to something else: Wendi Deng, one of its Chinese executives, became the third Mrs Murdoch. According to the *South China Morning Post*, a Hong Kong newspaper, the couple have acquired a huge Confucian-style home near the Forbidden City in Beijing. Mr Murdoch was brought into the Chinese government's inner circle—he shared a viewing of “Titanic”, made by his Fox movie studio, with then-president Jiang Zemin (who praised its depiction of class struggles). And in 2003, he lectured at the Central Party School that trains future leaders, and was called a “trusted mentor” of the Chinese TV industry.

Yet his insider status has not stopped News Corp from suffering alongside Viacom and Disney from a recent crackdown on foreign media in China, initiated by the new government under President Hu Jintao, to whom Mr Murdoch is far less close. True, News Corp may have pushed its luck. It has long been frustrated that it is allowed to beam its channels only to posh hotels and residential

compounds in Guangdong; now it is being investigated for allegedly setting up dummy companies to sell illegal decoders to ordinary people.

But, even if these allegations are true, News Corp would hardly be the first foreign company to test the limits of China's murky laws. Nor is Mr Murdoch the only businessman to curry favour with Beijing. Microsoft agreed to ban the word “democracy” from its MSN search engine in China, while Yahoo! says its decision to obey local data-protection rules, however unpalatable, is a cost of doing business in China. The real lesson is that a decade spent investing time and money to build relationships in China seems to have done Mr Murdoch little good. Having milked Star for its expertise, the Chinese may well feel they no longer need him.

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Business-school rankings

The year of listing differently

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The more the rankings differ, the less attention they receive

The gain in Spain
Leading business schools

2005 rank	2004 rank	Institution
1	9	University of Navarre *IESE Business School*
2	1	Northwestern University *Kellogg School of Management*
3	3	Dartmouth College *Tuck School of Business*
4	2	Stanford University *Stanford Graduate School of Business*
5	5	IMD - *International Institute for Management Development*
6	6	University of Chicago *Graduate School of Business*
7	10	New York University *Leonard N. Stern School of Business*
8	11	University of Michigan *Stephen M. Ross School of Business*
9	7	Columbia University *Columbia Business School*
10	19	University of California at Berkeley *Haas School of Business*
–	4	Harvard University *Harvard Business School*
–	8	University of Pennsylvania *Wharton Business School*

Source: Economist Intelligence Unit

Get article background

FOR the first time ever, a non-American institution has topped one of the leading rankings of business schools—the purveyors of the MBAs that are meant to be passports to a corner office and a six-figure salary. Heading the global ranking of business schools in the latest edition of "Which MBA?", published this week by the Economist Intelligence Unit (EIU), a sister organisation of this newspaper, is IESE Business School, an arm of the University of Navarre with campuses in Barcelona and Madrid (see table). In last year's EIU ranking, the first four schools were American; IESE was ninth.

The cream of such rankings is usually a coterie of six or seven American business schools. Among

these are Harvard Business School (HBS) and the Wharton School at the University of Pennsylvania in Philadelphia. This year, however, neither of these schools features in the EIU's list. This is not because they do not merit inclusion (last year they were fourth and eighth respectively). It is because they have chosen not to give the EIU access to the sources it needs to make its rankings.

The EIU's list is based on a number of criteria, but it relies heavily on students' assessments of their educational experience. In order to ask students their opinion it needs access to the schools' records, and it is here that HBS and Wharton have put their feet down. Arguing that it is a breach of their students' privacy, they have refused to hand over their contact details.

IESE topped the EIU's list because it scored particularly well in two categories: opening new career opportunities, and the starting salaries of its new graduates (their average—of $142,000—was higher than that at any American school). The *Wall Street Journal*'s ranking, also published this week, relies solely on recruiters' on-campus experience. Since it takes no account of students' views, it continues to rank HBS and Wharton—which came in 14th and 6th respectively in its latest listing of American schools. The *Wall Street Journal*'s top American choice was the Tuck school at Dartmouth College, which the EIU ranked third. But the *Journal* is much less impressed by IESE, which it ranks 19th globally.

Julia Tyler, associate dean of the MBA course at London Business School (which features highly in most lists, but not in the EIU's), points out that the interests of recruiters and students are not identical. Recruiters favour schools that provide a reliable stream of recruits; students want schools where they get the most job offers. Partly as a result, the EIU's and the WSJ's lists differ hugely.

Schools also complain that the proliferation of lists, since *BusinessWeek* launched the first in 1988, has left some staff working two to three days a week gathering information for the compilers. There are now so many business-school lists that they, too, probably deserve a ranking. Any top ten would include the EIU, the *Financial Times, Forbes*, *US News & World Report* and the *Wall Street Journal*.

Patrick Harker, the dean of Wharton, who made the first decision not to co-operate with the listmakers, also argues that “the ranking methodologies are severely flawed.” When asked by what criteria he would like his school to be judged, Kim Clark, who was the dean of HBS until the end of July, said “the achievement of its alumni”. But that is a lagging indicator. It might not make sense to choose HBS today just because its students of 30 years ago are now running many big companies.

The EIU is not the first to have been affected by the two schools' decision. The *Financial Times* (which owns 50% of *The Economist*) was unable to include them in its ranking of the best providers of executive-education programmes, which it published in May. This was despite the fact that Wharton and HBS had tied for first place in the FT's ranking of MBAs, published in January. The headline to the newspaper's article accompanying that listing read, “Two leaders leave the rest of the pack trailing”. (IESE came 12th in the FT's listing.)

And therein lies a dilemma. HBS and Wharton have such high reputations in the field that they have little to gain by appearing anywhere other than at the very top of the lists. HBS has the Harvard name, an influential journal (the *Harvard Business Review*) and a powerful publishing house (Harvard Business School Press) to sustain its reputation. Wharton has an online journal (knowledge@wharton) that is the envy of every other school, and a book published last month (“The Running of the Bulls: Inside the Cut-throat Race from Wharton to Wall Street”) that helps to propagate the carefully cultivated idea that to rise to the highest floors on Wall Street, you must first spend a couple of years in Philadelphia. The two schools say they have no intention of

changing their minds. But Wharton, in particular, may feel some pressure to restore the “buzz” that the listings can generate.

Culture shock

The listings are all produced by media organisations whose primary purpose is to entertain their readers. But they also aim to inform potential students of the merits of different courses. The EIU's “Which MBA?” includes copious details of the schools' features. Its ranking list is little more than a device to catch the potential reader's attention.

“Rankings are here to stay”, says Matt Symonds, whose company, QS, runs a website (www.topmba.com) that helps students to compile their own list of “best” schools. In the absence of a single incontrovertible measure of performance, the rankings provide a degree of accountability in an educational niche where there is too little. Mr Symonds's surveys show, however, that the more the lists proliferate and differ, the less attention students pay to them.

Choosing a place to study an MBA is a complicated decision that depends on a wide range of factors including geography, price and reputation. The listings, and the information that they distil, can help a student with that choice. There are plenty of things, however, that they cannot convey. None of the EIU's criteria, for instance, captures the distinctive culture of IESE. The institution is run by Opus Dei, a controversial Catholic order founded in the last century, and its professor of business ethics is a Roman Catholic priest.

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Economist.com BUSINESS

Face value

Technology's Mr Predictable

Sep 22nd 2005
From The Economist print edition

Getty Images

Michael Dell's money-making machine has further scope for growth

AS TECHNOLOGY executives go, Michael Dell is not, you might say, as colourful as some of his peers. Larry Ellison of Oracle has his huge new yacht and his fighter jet; Jeff Bezos of Amazon is funding a space-rocket start-up; Bill Gates of Microsoft has his enormous, high-tech house and a penchant for Leonardo manuscripts; Steve Jobs of Apple somehow combines counter-cultural cool with business smarts and a second job as a movie mogul. What about Mr Dell? He has four kids, a wife and three dogs, he shrugs. And no, he does not invest in rockets. His company, the world's largest maker of personal computers, is fashioned in Mr Dell's own forthright, no-nonsense image. It does not make sexy products—but, thanks to its straightforward direct-sales model, its brutally efficient lean-manufacturing approach and its unrivalled expertise in logistics and supply-chain management, it does make an enormous amount of money.

The way Dell makes and sells PCs is, in fact, the antithesis of the way Apple makes and sells its iPod music-players, which are arguably the sexiest technological devices around at the moment. Dell's PCs are based on industry-standard technologies. They are sold direct, through Dell's website. And the company's efficiency allows it to offer low prices, squeezing out less competitive rivals while still making a profit. The iPod, by contrast, is based on proprietary standards, is sold through Apple's glitzy chain of retail stores, and is priced at a premium to rival players. This week Dell launched a new music-player, the DJ Ditty (yes, really), as a challenge to Apple. As you would expect, it is cheap, powerful, but not terribly exciting. “Tape-backup drives are a far bigger business for us, or LCD projectors,” says Mr Dell. Such products, along with storage-area networks, servers and other bits of corporate-computing gear—only 15% of Dell's sales are to

consumers—may not be as glamorous, but are far more lucrative.

Dell's ability to churn out profits in a predictable and reliable manner has made it a favourite among investors. Look at the last ten years of sales data in the firm's 15 biggest markets—a total of 150 data points—and you will find that it increased its market share in 144 cases, says Mr Dell. That is strong evidence, he says, that his firm's business model “works everywhere, in a multitude of market conditions”.

But might the Dell machine be in danger of running out of steam? Last month, Dell announced that, despite record earnings, its second-quarter sales had grown by a mere 14.7%, rather than the 16-18% it had forecast, and that sales in the current quarter would also be slightly lower than expected. Its share price immediately fell by nearly 10%, and has since declined further.

The case against Dell was made most strongly by Laura Conigliaro, an analyst at Goldman Sachs, who downgraded Dell from “outperform” to “neutral” in a report entitled “A Miss With Much Wider Implications”. Dell is unlikely to return to reliable double-digit revenue growth in future, she argues. It faces increasing competition from Asian vendors such as Acer and Lenovo, and a widening gap between unit growth and revenue growth. And it is a far less nimble company than it used to be. “The company has now come up short of revenue expectations four quarters in a row, with each quarter's miss caused by a different combination of market conditions and execution miscues,” she wrote. In short, Dell is a victim of its own success: its scale means it is running out of room for growth, cannot respond quickly to changing market conditions, and no longer deserves to be valued at a premium to its rivals. Really?

Room for growth, outside America

Mr Dell says he has heard all this before, “maybe ten thousand or twenty thousand times”. Back in the 1990s, he recalls, critics claimed there were limits to the firm's direct-sales model, and suggested that Dell would never be able to make laptops or servers. “People say the sky has fallen, that it's the beginning of the end,” he says. “I don't agree. There are lots of markets with room to grow.” This week Kevin Rollins, who took over from Mr Dell as chief executive officer in 2004, said the company hopes to double or even triple its market share in Europe, which is around 13%, compared with 32% in America. Sales in the Netherlands, for example, are growing by 40% a year.

Dell's worldwide market share of around 19% means there is also room for growth in other regions, notably Asia. But won't low-cost Asian vendors be difficult for Dell to elbow aside? No, says Mr Dell. The firm is, in effect, an Asian vendor itself, with factories in China and Malaysia. Dell is more efficient than Lenovo, he says, and more profitable, thanks to its direct-sales model. Other growth areas are printers, storage systems and services. In printing, profit margins are unusually high, notes Mr Dell. “We'll fix that,” he says, just as the company did when it undercut the high-margin incumbents in the server business. Dell's services arm, meanwhile, which installs and manages computers for large companies, now represents 10% of its business, and is growing twice as fast as its PC division.

What of the charge that Dell's size means it is less responsive to shifts in demand? Mr Dell makes a point of making regular visits to the company's call-centres—and even takes a few calls himself—to make sure that he still understands consumer demand. On one of these visits, the deluge of calls received convinced him that the company had gone too far in slashing the prices of its consumer PCs—a move that had compensated for slowing demand from the American government, but hurt the firm's margins. Mr Dell enjoys his spells in the call-centre—they are, he says with relish, “lots of fun”.

Evidently Mr Dell's idea of fun is different from that of his peers, with their yachts, planes and spaceships. Like his firm, he is predictable rather than glamorous. But that is the way investors like it, and he intends to keep things that way.

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Economist.com WORLD ASIA

India's electricity reforms

Underpowering

Sep 22nd 2005 | DELHI AND MUMBAI
From The Economist print edition

AP

An electricity shortage may thwart India's rush to modernity

Get article background

ITS organisers are calling it a victory for people power. They even invoke the name of Mahatma Gandhi, icon of India's independence struggle. For economic reformers, however, it is a depressing defeat: by making a huge fuss and refusing to pay their bills in full, Delhi's middle class last month persuaded the local government to withdraw an increase—of about 10%—in the residential electricity tariff.

The protesters alleged they were being robbed by rigged meters and forced to pay exorbitant first-world prices for an unimproved, erratic third-world service. They had a point. But if not even well-off citizens in the capital will pay an economic rate for their power, what hope is there for the rest of the country, where politicians habitually offer free power to farmers in the hope of winning their votes? And while electricity boards continue to rack up huge losses, what chance is there of finding the money so desperately needed for investment in new generating equipment? More fundamentally, where will the fuel come from?

Power cuts are a way of life in India, at least in parts of the country lucky enough to regard them as an interruption rather than the norm. There is a worsening shortage. Over the past decade, electricity generation has grown at a compound annual rate of 5.5%, but demand has grown even faster. Peak demand exceeded supply by 11.3% in 1998 and by 12.1% in the last financial year (ending this March).

That, moreover, is to define demand in the narrowest of senses. The countryside, where more than two-thirds of India's people live, accounts for no more than 13% of electricity consumption.

India's 1.1 billion people use on average just 526 units (kilowatt-hours) of electricity a year, compared with 1,247 units in China. Where electricity is available it is often only for a couple of hours a day, unusable for industry and of such poor quality that power surges routinely wreck equipment.

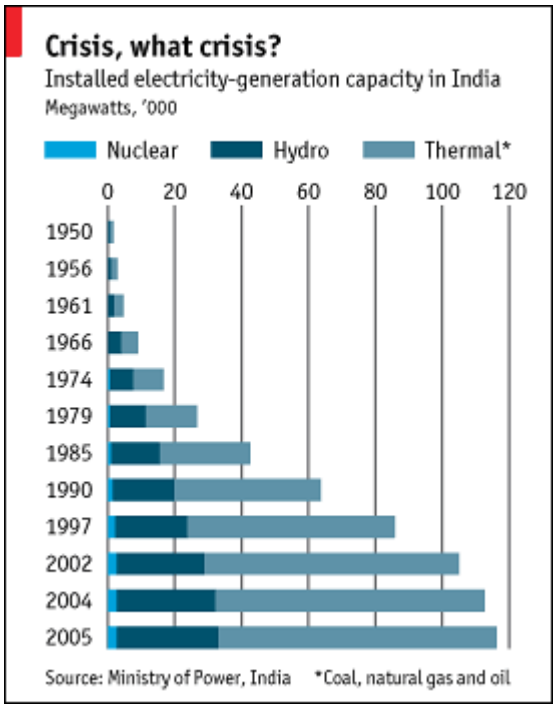
Yet India wants electricity to reach every village by 2008—demanding the electrification of 110,000 villages—and every household by 2012. At present, 56% of India's households, and just 44% of those in rural areas, have connections to the grid. Meanwhile, it is hoped that India's economy, already growing at an average of more than 6% for the past 15 years, will expand even faster, meaning more electricity-intensive manufacturing and air-conditioned shopping malls. The government talks of adding 100,000 megawatts (MW) of new generating capacity over the next ten years—a virtual doubling.

Indian industry, long used to the failings of the national grid, has survived by building its own “captive” generating plants. Azim Premji, chairman of Wipro, one of India's information-technology stars, senses that the electricity shortage is “coming to enough of a crisis now that we have to fix it, like we fixed telecoms.”

T.L. Sankar, an energy expert at the Administrative Staff College of India in Hyderabad, likewise draws succour from past successes in other fields, such as the near-doubling of food production in India during the “green revolution” of the late 1960s and 1970s. Something similar, he argues, is needed now.

“Crisis” may be the wrong word for such a long-standing shortage, with its origins in every link in the electricity supply-chain, from fuel through generation, transmission and distribution. But crisis is how it has sometimes felt during the last few months, because of a combination of factors. Manmohan Singh, the prime minister, has often spoken of the seriousness of the needs, and has set up a committee to tackle them. This summer, too, the oil price has soared and worries have mounted about a shortage of coal, which fuels about 60% of India's electricity, compared with about 26% from hydro-electricity and 11% from oil and gas.

A.P.J. Abdul Kalam, India's president and a much-respected scientist in a largely ceremonial post, has put the electricity shortage into the broader context of insufficient supplies of energy. In his speech on the eve of Independence Day on August 15th he called for efforts to make “energy independence” “our nation's first and highest priority”.



Always the worst season for power-cuts—air-conditioning provides respite from the sweltering heat—this summer has been particularly bad in some places, notably Maharashtra, India's wealthiest and second most populous state. Meanwhile, the row in Delhi has highlighted the mess that is India's electricity distribution.

Lost in transmission

Delhi had been held up as a model of successful power-sector reform. An Electricity Act in 2003 had achieved little, perhaps because it was so ambitious. Part of the difficulty lies in India's federal system, under which electricity is a “concurrent” subject, where both the central government and the 29 states have a role.

Except in a few cities that remained exempt, distribution was monopolised by state electricity boards (SEBs). The act called for the “unbundling” of generation from transmission and distribution, which was to be opened to private competition. Independent regulators would adjudicate tariffs, and the cross-subsidies that penalise industry to the benefit of the domestic consumer and farmer were to be removed. At present less than 42% of electricity is sold to industrial and commercial users, but that yields more than 70% of the SEBs' annual revenues.

Only two states—Orissa, in the poor east, and Delhi—have privatised distribution. The Delhi government claims that privatisation has brought big benefits. The two private firms involved, affiliates of the big national conglomerates, Reliance and Tata, succeeded in cutting losses to theft from about 50% of supply to about 40%—the national average. The government claims electricity was on its way to being “self-sustaining”.

This picture of healthy progress, however, does not match popular perceptions. Reliance, in particular, is accused of having behaved badly. Much suspicion has centred on new digital meters. Reliance denies they run too fast, arguing they are more sensitive than the old mechanical ones. So electricity bills would have risen sharply anyway.

Degenerating

The timing of the furore in Delhi is unfortunate. Electricity reforms have stalled, and may slip into reverse. Communist parties, on whose votes the government led by Mr Singh's Congress Party relies for a parliamentary majority, want to water down the 2003 Electricity Act. Jealously protective of the interests of public-sector workers, they oppose unbundling and privatisation, and support cross-subsidies.

Already, Congress-led state governments have been among the worst offenders in using electricity to buy votes and popularity. Some of Maharashtra's troubles, for example, can be traced to elections held last year, when the government offered farmers free power for irrigation pumps. Maharashtra was forced to remove the sop this June, but other Congress-led governments, most recently in Punjab, have offered the same handout.

One consequence of failing to fix the SEBs is fiscal. Their average tariff has risen by 20% since 2000, compared with a rise in the cost of their supplies of just 4%. But still, tariffs, on average, are just three-quarters of supply costs. Some estimates suggest that the SEBs lost 10 trillion rupees ($215 billion) over the past decade. This has damaged their ability to add distribution capacity, and even to carry out basic maintenance. The Planning Commission has pointed out that more than 90% of the investment in the power sector goes into generation and transmission rather than distribution, akin, it argues, “to building a superstructure without a foundation”. Still, the money needed for new generating capacity is huge—estimates range between $10 billion and $15 billion a year.

Efforts to attract private investment, including from abroad, into power generation have been largely unsuccessful. The most spectacular failure was the impressively modern 2,200MW Dabhol power project in Maharashtra, which started operation in 1999, only to shut in 2001 after a row between its promoter, Enron, a collapsed American energy giant, and the SEB. Years of legal wrangling have ensued, with damaging effects all round. Many Indian observers drew the lesson that privatisation and foreign investment in power did not work and meant high prices. Foreign firms wondered whether power-purchase commitments signed by bankrupt SEBs were worth anything. Only now is the project restarting, having, in effect, been nationalised. It will be at least a year before it is producing electricity.

Despite Dabhol and a huge gas-fired plant that Reliance is building in Uttar Pradesh, a northern state, coal is expected to remain India's “mainstay” fuel for decades to come. Its proven reserves, of 92.4 billion tonnes, are just over 10% of the global total. But it is of low quality, with a high ash content and low calorific value. It is also, by international standards, expensive (perhaps twice the cost of South African coal), and production is not growing fast enough. Rajiv Sharma, a senior official in the Ministry of Coal, blames this on underinvestment in the 1990s, when coal became a “condemned fuel”, because of its polluting effects and contribution to global warming.

Coal India, the state's near-monopoly, was unprepared when demand took off in 2003. So India has been importing more coal—nearly 11m tonnes last year. Vipul Tuli, of McKinsey's, a consultancy, predicts a “massive” shortage of 100m tonnes by 2011-12. Domestic coal usage is constrained and made more costly by an inadequate rail network. Imports are hampered by a lack of capacity at the ports.

Recent months have seen a scramble by India to secure fuel supplies. There is talk of pipelines to bring gas from countries such as Turkmenistan, Bangladesh, Myanmar and, most controversially, Iran. Meanwhile ONGC, a state-owned oil exploration and production company, has teamed up with Lakshmi Mittal, a steel tycoon, to bid for foreign oil assets.

India's nuclear industry, which at present supplies about 2% of electricity, received a big boost in July, when Mr Singh went to Washington, DC, and secured an American offer of help for it. Despite having nuclear weapons, which it tested in 1998, India has never signed the international non-proliferation treaty. So this was a diplomatic coup. Mr Singh has suggested India could have 30,000 to 40,000MW of nuclear capacity for the next 20-30 years. But that optimistic figure is still a fraction of requirements.

There may be more potential in hydro-electricity, which already produces a quarter of India's needs, in renewable forms of energy, and in moderating demand by enhancing energy-efficiency. India has an estimated 120,000MW of untapped hydro-electric potential. Big dams are controversial, but much of this could be realised through small, run-of-the-river projects. It is hoped to increase hydro's share in production to 40%. The “most significant” strategic goal set by Mr Kalam in his Independence Day speech, however, was to increase the share of renewable energy in generation from around 5% now to 20-25%. Wind power already accounts for about 2%. Solar power is negligible now, partly because of the high capital cost of solar plants, but the president was optimistic that new technology would soon bring the cost down. He estimated, moreover, that 30m hectares of wasteland in India are available for the cultivation of “bio-fuels”, such as Jatropha, an oil-producing shrub.

An obsession with “energy security” may not be wise in a world where, in Mr Singh's words, borders are becoming less relevant. But it must make sense to look at options other than coal and imported hydrocarbons. The impediments to meeting India's needs through increases in thermal-power generation seem likely to dog the country's progress for years. They lie not just in the present shortages of fuel and capacity, but in the structure of an industry too long governed by political rather than economic concerns. They are not insuperable. But they are so complex and daunting that one leading industrialist privately argues that the only solution is for electricity to be declared a national emergency. That way, the general recognition of the scale of the challenge might actually turn into action.

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Economist.com FINANCE & ECONOMICS

Global monetary policy

A nasty whiff of inflation

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From The Economist print edition

AP

Thanks to higher oil prices, inflation is creeping up all around the world

INFLATION was supposed to be dead. Yet back-of-the-envelope estimates by *The Economist* suggest that in September America's 12-month rate of consumer-price inflation will jump above 4%—the highest since 1991. If so, this more than justifies the Federal Reserve's decision this week to raise its fed funds rate by another quarter of a percentage point, to 3.75%. Despite calls from several American politicians and economists for a “compassionate pause” in the Fed's tightening, because of fears that Hurricane Katrina could depress economic output, the Fed is more worried about the risk of higher inflation than about slower growth.

Average petrol prices in America fell back to $2.76 a gallon this week, from a peak of $3.07 a fortnight ago. However, the immediate path of prices is uncertain: Hurricane Rita, an even bigger storm that was heading for Texas this week, may well do further damage to America's Gulf coast refining capacity. Even without an extra push from Rita, the average price of a gallon in September will be well above that of last month, giving consumer-price inflation, already 3.6% in August, an extra fillip.

Petrol prices have also taken their toll on consumer confidence: the University of Michigan's index plunged in early September to its lowest level since 1992. The fall since July has been the largest two-month drop since records began in 1978. If the recent decline in petrol prices continues, however, consumers' fears should ease. The huge planned post-Katrina increase in government spending, of up to $200 billion, should help underpin the economy.

Much more alarming was the sharp jump in inflation expectations in the same survey. Consumers

now expect prices to rise by 4.6% in the coming year, having forecast 3.1% in August. Their guess for inflation over the next five to ten years rose to a four-year high of 3.1%, from 2.8% (see chart). Higher spreads on inflation-protected Treasury bonds and a rise in gold prices, to a 17-year high of $470 an ounce, also suggest that an increase in inflation is thought to be on the way.

The Fed signalled this week that it intended to keep pushing interest rates higher. Despite 11 increases since June 2004, monetary policy is still loose. Using August's inflation figure, real interest rates are barely positive, while bond yields are lower than before the Fed started to raise rates. Such monetary laxity has been fuelling America's housing bubble—and now it risks feeding wider inflation.

In its statement this week the Fed stressed that core inflation—a measure that excludes energy and food prices—has remained relatively low, at only 2.1% over the past year. The core inflation rate was invented in the 1970s as a way to exclude the impact of temporary food and oil supply shocks, and so allow the Fed to focus on the underlying trend. The snag is that the current rise in oil prices looks much more permanent than previous spikes. Moreover—at least until Katrina came along—the rise in world oil prices has mainly reflected strong demand (partly due to robust growth in America) rather than a disruption of supply, and may therefore be a symptom of more general inflationary pressures.

Stephen Roach, the chief economist at Morgan Stanley, worked at the Fed in the 1970s under the then chairman, Arthur Burns. He remembers the dangers of core inflation. When oil prices surged in 1973-74, Burns asked the Fed's economists to strip out energy from the consumer-price index (CPI) to get a less distorted measure. When food prices then rose sharply, they stripped those out too—followed by used cars, children's toys, jewellery, housing and so on, until around half the CPI basket was excluded because it was supposedly “distorted” by exogenous forces. As a result, the Fed failed to spot the breadth of emerging inflationary pressures throughout the economy.

Lesson learned

It looks unlikely to make the same mistake this time. Companies are already passing on some of their higher fuel costs. In recent weeks, airlines and delivery firms have raised fuel surcharges. Dow Chemical has announced price increases for all of its chemical and plastic products. Businesses are also facing rising labour costs. Unit labour costs rose by 4.2% in the year to the second quarter, as productivity slowed and wage growth picked up. A year earlier unit labour costs were actually falling. Adding all this together, David Malpass, an economist at Bear Stearns, forecasts that the annual rate of core inflation could reach 3% in the coming months.

It is not only America that is experiencing creeping inflation. Economists at CSFB forecast that higher oil prices will push the euro area's inflation rate up to 2.6% this month. That may not sound so bad, especially when core inflation still remains well below the 2% ceiling of the European Central Bank's (ECB) target. However, the euro area's official inflation rate probably understates reality, because it excludes the costs of owner-occupied housing. Adding these in would probably push this month's inflation rate above 3%.

This weakens the case of those clamouring for the ECB to cut interest rates from their current 2%. Real interest rates in the euro area are already negative, and now, with inflation moving up, the ECB is even less likely to ease policy.

CSFB is also betting that Britain's inflation rate will rise to 2.8% in September, its highest since 1995 and well above the Bank of England's 2% target. This appears to vindicate the vote by Mervyn King, the Bank's governor, against August's quarter-point cut in interest rates to 4.5%. The minutes of the September meeting, published this week, showed that in its latest deliberations the rate-setting committee was unanimous in holding rates steady.

In Japan talk of inflation is still premature, but deflation may at last be coming to an end. The Bank of Japan and most private-sector economists expect the year-on-year change in the core CPI (which in Japan excludes only fresh food) to turn positive before the end of this year. The Bank of Japan has said that it will not tighten monetary policy until the core rate of inflation has been above zero for several months and is expected to stay there.

With inflation edging up almost everywhere, is there a risk of a repeat of the 1970s? A burst of double-digit inflation seems unlikely. Prices took off in the 1970s largely because of serious policy errors. Policymakers now understand that rising inflation harms growth, and independent central banks are more likely to stamp on inflation swiftly.

The real worry with rising inflation expectations is less that they herald a surge in inflation than that they will limit the ability of the Fed or other central banks to cut interest rates if growth stumbles. It is commonly argued in America that if the housing bubble were to burst, and falling house prices threatened to choke consumer spending, the Fed would slash interest rates to prop up the economy, as it did after the stockmarket bubble popped in 2001-02. But then inflation was falling. Today, with inflation rising, the Fed would no longer have that option. If the economy hits trouble, investors and homebuyers should not expect to be bailed out again.

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Economist.com FINANCE & ECONOMICS

Fund management

Semper Fi

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Slashed fees at Fidelity set a challenge for Britain's fund managers

FIDELITY, Britain's biggest fund manager and America's third-biggest, is the commando squad of the world's investment community. A bold decision this week to reduce the management charge on its British stockmarket-tracker fund to almost nothing has rattled its rivals. And with reason: a similar move by the firm in America last year prompted investors to pour new money into its indexed funds. In Britain the cut, though welcome, is unlikely to stand the £308 billion ($558 billion) industry on its head. But it confirms other developments which could.

High Fidelity
British funds under management, £bn

July 1998		July 2005	
Schroder	13.8	Fidelity	29.1
M&G	10.0	Invesco Perpetual	16.2
Fidelity	8.5	Threadneedle	15.2
Perpetual	8.1	Legal & General	14.1
Mercury	7.6	Scottish Widows	12.5
Threadneedle	7.3	Halifax	12.0
Gartmore	6.8	Schroder	11.2
Barclays	6.2	M&G	10.8

Source: Investment Management Association

Fund management, like many things in Britain, is hideously expensive. And the charges are complicated. From October 1st, investors in Fidelity's MoneyBuilder UK Index Fund, which mimics the FTSE All-Share Index, will pay an annual management charge of only 0.1%, down from 0.5% now. Firms that are bigger in indexed funds (Fidelity is better known for active management) charge more, ranging from F&C's 0.3% to Virgin Money's 1% and beyond.

But annual management charges are only one element of the fees that an investor pays. Because Fidelity unbundles fund-management and administration fees more than most, its total expense ratio will come to 0.3%—only fractionally lower than F&C's all-in 0.35% and not far below market leader Legal & General's 0.52%. That is not enough to provoke a stampede in a country where retail investors are remarkably insensitive to price (as their profitable high-street banks can testify). So perhaps rivals are not bluffing when they say that they will not follow suit.

These numbers may seem too small to worry about, given the 1.5% in management charges that actively managed equity funds typically collect. But indexed funds do not employ rocket scientists to reproduce the market return. And when returns to fund investors are less than spectacular, costs matter.

The biggest costs in fact have less to do with managing money than with getting it. To buy an actively managed equity fund (and even some indexed funds) usually costs an investor 5% in front-end fees, of which three-fifths or more goes to the person who sold the fund: almost 80% of retail investors buy their funds through intermediaries, says the Investment Management Association, a trade group.

But things are changing, thanks to a shove from institutional investors that is beginning to feed through to the retail market. Huw van Steenis, head of asset management at Morgan Stanley, an investment bank, describes it as “the asset-management barbell”; others call it the “separation of alpha from beta”.

Traditional asset management is under siege from two directions, he says. On the one hand, indexed funds offer a cheap way to obtain the market return—ie, get its “beta”. On the other, spicier strategies—often concentrated “best ideas” portfolios, hedge-fund techniques or structured products—provide over-the-odds “alpha” returns. The funds that aim to beat a benchmark by just a little and usually fail (after costs) to do so are being retired.

Where does Fidelity fit in this scheme of things? Richard Wastcoat, its managing director in Britain, does not disguise his hope that investors enticed into equities through his tracker fund will come to invest in active funds as well. But the merit of the move lies in recognising indexed funds as commodities and pricing them as such. Fidelity is far from the first to see this, but it has acted on it more decisively than any of its rivals. In today's barbell world, Fidelity has just set the price for beta.

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Economist.com FINANCE & ECONOMICS

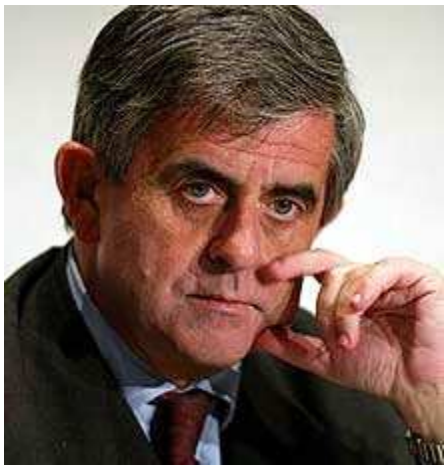
Financial exchanges

Ménage à trois

Sep 22nd 2005
From The Economist print edition

Shareholders stir things up again at Europe's big exchanges

Reuters



Something for Théodore to think about

THE suggestion may have been a warning shot rather than a serious proposal. Nevertheless, the thought offered this week by Harris Associates, a Chicago investment firm, that Euronext and Deutsche Börse should merge with each other rather than pursue the London Stock Exchange (LSE) caused a flutter on the other side of the Atlantic. Harris's opinion counts because it owns shares in both suitors, which are also rival financial exchanges. Other shareholders are reported to share its views. Not surprisingly, neither exchange is saying anything.

Deutsche Börse's interest in the LSE is in abeyance: a shareholder revolt against it cost Werner Seifert, the firm's chief executive, his job earlier this year. Still, the timing of this latest sign of activism among the exchanges' shareholders is awkward for both Jean-François Théodore, Euronext's chief executive, and Reto Francioni, nominated last week as Mr Seifert's successor, because Britain's competition authorities are in the midst of a review of both firms' informal approaches to the LSE. But that may be the point: rather than waiting for a ruling, due by November 7th, some investors seem concerned about the time and money Euronext has spent wooing the LSE. “No one wants anyone to pay a loopy number for the LSE,” says a London analyst. Harris's concern was that Euronext might make a bid “materially higher” than 500p ($9.06) a share. LSE shares closed on September 21st at 579½p.

Sceptics contend that Deutsche Börse's and Euronext's models are incompatible. “I'm not sure they [the investors] know what they're asking for,” says Benn Steil, an expert on exchanges at the Council on Foreign Relations in New York. Deutsche Börse takes a “vertical”, do-it-all approach. Besides cash equities (in essence, the Frankfurt stock exchange) and Eurex, the world's largest derivatives business, it also earns plenty from Clearstream, its clearing arm. Euronext, fruit of the merger of several European exchanges, is much larger than Deutsche Börse in cash equities (as is the LSE) and has a decent derivatives business in Liffe, but has largely separated itself from clearing and settlement.

If all the wooing and bickering seems excessive, consider the stakes: publicly traded exchanges have been a hot sector in recent years. Since December 1st, Deutsche Börse's stock price has risen by more than 65% and Euronext's has increased by more than 50%. The LSE's has surged too; and good first-half results this month would do it no harm. Exchanges that have not yet gone public are generating interest as well. Witness the member-owned New York Mercantile Exchange, which has been pursued by two private-equity firms and a consortium led by its former chairman. On September 20th it said that General Atlantic, one of the private-equity groups, had signed a non-binding letter of intent to pay $135m for a 10% stake.

A deal between Deutsche Börse and Euronext, should it ever happen, could have effects in America as well as Europe. The Europeans have tried to take business from Chicago's two big derivatives exchanges, the Chicago Board of Trade, whose initial public offering is expected next month, and the Chicago Mercantile Exchange; combined, they would pose a bigger threat than they have hitherto. John Lothian, who edits a newsletter on the derivatives industry in Chicago, contends that a possible European tie-up could ease the concerns of American regulators about an intra-Chicago merger; lately, there has been a lot of gossip about just such a union. “There would be more leeway in Washington”, he says, “for a super-derivatives exchange in the US.”

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Economist.com FINANCE & ECONOMICS

Europe's ex-communist economies

Baltic blues

Sep 22nd 2005 | TALLINN AND WARSAW
From The Economist print edition

An unusual problem: labour shortages

Get article background

SINCE the collapse of communism, it is jobs not workers that have been in short supply. But that's changing. Employers in Estonia, Latvia and Lithuania, where growth rates are over 7%, now complain of labour shortages. Last month Elcoteq, the country's best-known foreign investor, started busing 150 workers from Narva in Estonia's hard-up north-east to work at its big mobile-phone plant in the capital, Tallinn. When it opened in the early 1990s, would-be workers from the city's grim suburbs queued overnight to apply.

One reason is a boom in labour-thirsty business: Latvia's construction industry, for example, jumped 16% in the first half of 2005. Membership of the European Union is bringing foreign investment and outsourcing. That stokes manufacturing. Tourism is soaring, meaning more jobs in restaurants and hotels. And wages are growing by around 10% annually, meaning higher spending power and more jobs in shops.

Officially, unemployment is still around 8% in all three countries. But some of the jobless are not easily employable: “Too old, too drunk or too lazy,” says one official unkindly. More importantly, many are working, either illegally at home or elsewhere in the EU. When Latvian teachers recently demonstrated for higher salaries, one placard threatened “see you in Ireland”—which, like Britain, has opened its borders to workers from the EU's newest members.

Indeed, in Britain there may be 100,000 workers from the Baltic states (combined population: under 8m). Poland, with nearly 40m people, reckons that 300,000 of its citizens are working in Britain. Polish building firms are complaining of labour shortages—though unemployment is officially 19%.

One solution is better labour mobility: if money can tempt workers across a continent, it can also shift them around at home. But though higher wages please voters, they worry governments. Central and eastern European countries need to nudge inflation still lower if they are to qualify to adopt the euro. Higher labour costs may also threaten competitiveness. A big Lithuanian knitwear firm, Utenos Trikotazas, has shifted production to low-wage Ukraine.

But the most controversial idea is to import extra workers. Poland has tens of thousands of illegal immigrants, chiefly from Ukraine: now the talk is of making it easier for them to work legally. In Latvia, VP Market, a retail chain, wants to hire staff from neighbouring Belarus; other firms are thinking along similar lines. That may make business sense, but in the Baltic states, where many still see Russian migrants as a lasting and unwelcome reminder of Soviet occupation, such notions are regarded with horror.

Economist.com FINANCE & ECONOMICS

Brazilian bonds

Real step forward

Sep 22nd 2005 | SÃO PAULO
From The Economist print edition

The first bond in Brazil's own currency

EMERGING markets are tainted in investors' eyes by “original sin”: they must borrow from rich foreigners in the foreigners' currencies. When investors worry, those currencies jump, increasing the borrowers' burden, sometimes through no fault of their own. Brazil, the world's biggest emerging-market debtor, knows all about original sin, having endured a series of painful devaluations over the decades. On September 19th it gained something akin to absolution, by issuing its first international bond in its own currency, the *real*.

Brazil is not the pioneer. Uruguay issued an international peso bond in 2003 and Colombia followed last year. Other countries, such as Mexico, make it easy for foreign investors to buy domestic bonds. Brazil has a giant domestic debt market, where interest rates are among the world's highest, but makes it hard for foreigners to invest. The new bond pays *real* interest rates without the red tape, and investors queued up. At 3.4 billion *reais* ($1.5 billion), the bond is twice the size first planned and dwarfs earlier Euro-peso issues; at ten years, its maturity is longer than on any other fixed-rate government paper in Brazil. High-yield borrowers elsewhere, such as Turkey, could follow the Latins' lead.

The attraction in Brazil's case is a junk-bond yield—12.75% on the Euro-*real* issue—from an economy that looks less and less junky. Thanks to strong demand for commodities and other products, Brazil is enjoying an export boom that has chopped the ratio of its foreign debt to its revenues and driven the *real* upwards against the dollar. A tight fiscal policy is helping to push down public debt, from 84% of GDP at the end of 2002 to 75% by the end of this year, forecasts Fitch, a rating agency. The central bank, having smacked down inflation, cut interest rates last week for the first time since April 2004. Investors are locking in today's high rates, and betting that the *real* will stay firm even as they drop.

Until now, only investors willing to open accounts and pay taxes in Brazil, mainly locals along with foreign banks and hedge funds, have been able to buy *real* paper yielding close to 20%. Others have had to content themselves with Brazil's dollar-denominated bonds, which yield a scant 7.4% or so for the ten-year version. The Euro-*real* bond has breached that wall. The government is trying to make it easier for foreigners to tap the domestic markets directly, says Joaquim Levy, a senior finance-ministry official.

Dollar financing would be cheaper; but the new issue will both dampen domestic interest rates and provide a hedge against depreciation. Foreigners have less vivid memories of hyperinflation than locals do, one reason why they are more willing to lend long-term at fixed rates. Arbitrageurs will now sell the ten-year bond and buy shorter-term securities with higher yields, “encouraging lower interest rates at the short end”, says Luis Fernando Lopes of Banco Pátria, a merchant bank. It all looks promising, as long as the government remembers that the true original sin is a reckless economic policy.

Economist.com FINANCE & ECONOMICS

A bank run in Macau

Breaking the bank

Sep 22nd 2005 | MACAU
From The Economist print edition

They do more than gamble in Macau

BANK runs don't happen often these days—almost as infrequently as, say, dictators embracing disarmament. But just days before North Korea's tentative conciliatory step this week (see article), a Macau bank found itself in trouble, having been suspected of illegal financial links with the pariah state.

Last weekend, nervous depositors in the former Portuguese colony queued outside branches of Banco Delta Asia. They wanted their money out because on September 15th the American Treasury's Financial Crimes Enforcement Network (FinCEN) had branded the bank "a willing pawn for the North Korean government to engage in corrupt financial activities". FinCEN alleges that for 20 years Banco Delta Asia has been providing "financial services", including circulating counterfeit money and laundering suspicious cash deposits, to North Korean firms linked to the smuggling of drugs, fake tobacco and precious metals. Under particular scrutiny is Zokwang, a trading company that is also, in effect, Macau's North Korean consulate.

Banco Delta Asia calls the accusations "totally unfounded". Its chairman, Stanley Au, a former gold trader and a Macau legislator, says they are a "ridiculous joke". He says that the monetary authorities in Macau and Hong Kong have known about the bank's relationship with North Korea for years, but that he has now suspended business with North Korean firms.

Mr Au says too that the money customers withdrew in last weekend's panic—around HK$300m ($38m), or 10% of the bank's deposits—is coming back. An appeal for calm by Macau's leader, Edmund Ho, helped. So has the government's rapid promise to support the bank and its appointment of two representatives to the management team. Meanwhile, Banco Delta Asia has hired a law firm to persuade the Americans to remove it from their money-laundering blacklist, which in effect cuts it off from the international banking system.

Reports say that Bank of China and Seng Heng Bank, controlled by Stanley Ho, a Macau casino billionaire who part-owns a casino in Pyongyang, are also under investigation. Bank of China says it has no knowledge of a probe. Banco Seng Heng's general manager, Robert McBain, says it has no business with North Korean companies or citizens.

Macau's reputation is already fragile, and suggestions that the gangland violence of the 1990s has been replaced by commercial crime do it no favours. FinCEN notes that "money-laundering has been identified as a significant problem in Macau" and chides the ex-colony for failing to pass the anti-laundering laws that it first promised in 2003. One reason for the delay may be a reluctance to slow the flow of money into Macau's economy, which is thriving from a boom in tourism, gambling and property development. Life might be easier for Macau's businessmen if the only people trying to break the former colony's banks were punters in its casinos, not the American government.

Economist.com FINANCE & ECONOMICS

Canada's income trusts

Cold shower

Sep 22nd 2005 | OTTAWA
From The Economist print edition

Official worries about a Canadian financial craze

Get article background

THERE were cries of alarm from Toronto's financial district this week, when the Canadian finance ministry said that companies thinking of turning themselves into "income trusts" would no longer receive advance approval from the tax authorities. How, asked the bewildered of Bay Street, the heart of the financial district, could the government in effect call a halt to the hottest action on the Toronto Stock Exchange?

But the party may be over

Canadian income trusts listed on Toronto Stock Exchange, June 2005

	No of issuers	Market cap C$bn
Business trusts	126	49.5
Energy trusts	37	60.3
Real-estate investment trusts	26	20.7
Power and pipeline trusts	20	17.1

Source: TSX Group

How could it not? Canada has seen a frenzy of conversions in recent years as companies shed their traditional structure in favour of an income trust, which shifts the tax burden from the corporation to the investor and denies the taxman perhaps C$300m ($256m) a year. In the first half of 2005, income trusts accounted for more than 70% of the C$2.6 billion raised in initial public offerings. Another C$3 billion-worth are in the pipeline. In property and energy, income trusts have been around for almost 20 years, but most of the new activity has been in "business income trusts", involving everything from a pizza chain to the newspaper operations of a media conglomerate.

The loss of tax was one source of worry for the government. Although income from trusts is taxable, lots of it has been slipping through the net, partly because the trusts' investors were tax-exempt pension funds or individuals stuffing money into tax-protected retirement accounts. A flood of new trusts would create a gaping hole. The finance ministry was also worried that corporations were turning substantially all their earnings over to investors, rather than reinvesting in the business. Income trusts were designed for mature companies, with stable earnings and little need of capital investment. Not all the new trusts fit this profile.

Separately, Canada's provincial securities commissions had expressed concern that these sophisticated investments were being marketed to investors who might not understand that they were buying the promise, rather than the certainty, of a future income stream. Even the central bank was fretting about investors loading their portfolios with high-risk assets, such as income trusts, in search of higher returns.

The finance ministry tried last year to limit the growth of business income trusts, but was forced to back down by a fierce business lobby. This time around, it has said it will wait until the end of the year before deciding whether to change the tax system. It issued a consultation paper earlier this month.

On Bay Street, they carried on regardless. On the day the paper came out, CI Fund Management, Canada's second-largest mutual-fund company, announced plans to convert. Several days later,

the head of the Royal Bank of Canada, the country's largest bank, mused publicly about the possibility.

It was all too much for the finance ministry, which decided the overexcited sector needed a cold shower. The stockmarket was doused: shares in potential candidates for conversion tumbled the day after advance tax rulings were stopped. TSX Group, which runs the Toronto exchange and was itself pondering trust status, saw its shares fall by 11%. Many putative converts will now wait until the consultations are over and the government has made its decision. This, of course, is what the government wanted in the first place.

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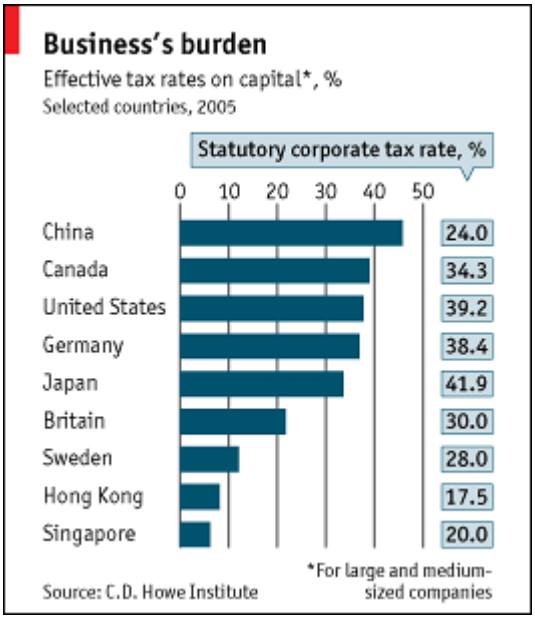
Economist.com FINANCE & ECONOMICS

Investment taxes

Taxing times

Sep 22nd 2005
From The Economist print edition

A study of corporate taxes yields some unexpected results



SWEDEN, a bastion of egalitarianism where the state claims around 60% of GDP, is surprisingly friendly to capitalists. On the other hand, communist China, the darling of foreign investors the world over, demands a great deal from its suitors. Both findings emerge from a new report on capital taxation by Duanjie Chen, Jack Mintz and Finn Poschmann of the C.D. Howe Institute, a Canadian think-tank.

The simplest way of comparing countries' capital taxation would be to look at statutory tax rates on corporate income. But that, says the authors, misses a lot of factors that affect the taxes which firms actually pay. Governments use different rules for the treatment of depreciation, inventories and other things. All of these cause actual tax rates to diverge from the statutory figures.

The authors have calculated a ranking according to the "effective" tax rate—the proportion of the pre-tax return on capital swallowed by the state (see chart). China comes out on top, largely because of a 17% value-added tax on purchases of machinery and equipment. However, lucky firms can sometimes negotiate a full refund, which cuts the effective tax rate from 46% to only 18%.

Canada, America and Germany are also among the top corporate taxers. Although Canada has a lowish statutory tax on corporate income, high capital and sales levies on inputs by its provincial governments lift its effective rate.

Sweden allows fast write-offs for capital investment, which pull its effective tax rate down. Singapore and Hong Kong also offer liberal deductions and concessions that yield more favourable tax regimes.

How important are tax policies in encouraging foreign direct investment? All other things equal, a higher tax rate reduces the return on investment. However, all other things are seldom equal: differences in market size, labour costs, the quality of infrastructure and political stability, among other things, are also important for attracting investment. Foreign investors falling over each other to set up factories in China are plainly not put off by tax.

Still, the authors believe that taxes do matter, and increasingly so for industrialised countries that face stiff competition for investment, especially from the Chinese. In Germany, corporate-income taxes may be on the way down whatever the colours of the next government. Similar pressures

may lead America and Canada to cutting their rates as well.

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Economist.com FINANCE & ECONOMICS

Economics focus

Unlikely revolutionaries

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From The Economist print edition

The World Bank cannot go where its research is leading it

THE cover carries a fresco by Diego Rivera, a Mexican revolutionary and artist. The text within bemoans the many ways, overt and covert, in which elites protect their interests and hold down the poor. In response, it advocates policies that will challenge the privileged and empower the disenfranchised. The World Bank's latest *World Development Report* (WDR), published this week, is heady stuff: more than 200 pages arguing that the Bank itself, as well as the governments it helps, should put "equity" at the forefront of their thinking.

The WDR is not quite as radical as this sounds. By "equity", it means equality of opportunity, not equality of outcome (except that people who squander their opportunities entirely should be spared the worst of outcomes). A person's fate should be decided by effort, talent and luck, not race, caste, gender or inherited privilege. Philosophers will wonder why the talented, who did not earn their God-given abilities, deserve their rewards any more than the well-born, who did not choose their parents. Such cavils aside, there is little here to which a liberal could object.

Some people prize equity for its own sake. But the WDR sees equity primarily as a means to the end of economic development. Redistribution of "access to services, assets or political influence" can be a way to make the economy as a whole more efficient. It is not an ideological imperative so much as a technical fix: a second-best response to market failure.

This claim is best illustrated in the report's chapter on inequality and investment. It shows that failures in the markets for credit, insurance, land and human capital result in underinvestment by the poor, overinvestment by the rich and a less efficient economy. To understand this, it is necessary to appreciate how markets should work in an ideal world—because if they worked as economists would like, they would deliver much of the equity the WDR would advocate.

In a perfect credit market, the WDR points out, there should be no connection between wealth and investment. A free market in capital breaks the link between the amount people own and the amount they can invest. In such a market, anyone can borrow or lend as much as they want at the going rate of interest.

In reality, the rich and poor borrow on very different terms. Much of the research cited in the WDR is several years old, but this is an area in which economic power shifts slowly. According to a 1989 study of six villages in the south of India, the rich were typically asked to pay interest rates of 33%, while the poor borrowed at rates of over 100%, when they could borrow at all. This is partly because lenders ask for collateral that only the well-off can provide.

In addition, banks and other lenders maintain a spread between the rate they pay on deposits and the rate they charge on loans. This is, of course, how they make their money. But in poor countries, this spread widens to alarming proportions. The same 1989 report found that India's informal "finance corporations"—which act much like banks, although they cannot issue cheques

or transfer funds—paid 12% at most on deposits of less than a year, while charging at least 48% on loans.

This gulf between loan rates and deposit rates contributes to the misallocation of capital, the WDR points out. Whereas poorer entrepreneurs invest someone else's money, richer entrepreneurs often invest their own. For the poor, an investment is worthwhile only if its returns exceed the cost of capital, ie, the rate they must pay on money borrowed from the bank. For richer entrepreneurs who can finance themselves, on the other hand, an investment is worth doing if it exceeds the opportunity cost of capital, ie, the rate they can earn by putting their money in the bank. In a perfect credit market, the spread between these two rates, the deposit and the loan rate, would be wafer thin. But in poor countries, it is often unbelievably fat.

As a result, some firms are starved of capital, while others have more than they can usefully digest. Small Mexican firms with less than $200 invested in them had rates of return as high as 15% a month, according to one study. By contrast, rates of return for larger firms, with more than $900 invested, were often negative. Ghanaian pineapples provide another striking example. Turning to pineapple production from maize and cassava promised average returns of more than 1,200%, according to a 1999 study by Markus Goldstein and Christopher Udry of Yale University. But only 190 of the 1,070 plots studied were devoted to the juicier crop. Farmers said they could not afford to switch.

Willing the end, but not the means

The Bank's solutions to these particular inefficiencies are by now familiar: extending microfinance, for example, or giving the poor formal title to their land and property so they can offer it as collateral. But it also argues that the best policies for fighting poverty might involve “redistributions of influence, advantage or subsidies away from dominant groups”. It hastens to add that expropriating the rich might not be good for investment. But even when they are desirable, such usurpations are not necessarily feasible. A dominant group is, by definition, one that tends to guard its influence, advantage and subsidies jealously and, on the whole, successfully.

In the end, the WDR would probably disappoint the revolutionary who provided its cover image. The Bank is in no position to overturn dominant elites. These are, after all, the people with whom the bank must deal. The WDR is a report, not a manifesto, and contains the usual bureaucratic disclaimer. “It is neither the mandate nor the comparative advantage of the World Bank to engage in advice on issues of political design,” it says. The Bank cannot do much about many of the deep-seated injustices and inequities it analyses in its report. But with its charts, tables and numbers, it paints an arresting mural nonetheless.

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Economist.com SCIENCE & TECHNOLOGY

Flu vaccine

Preparing for a pandemic

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From The Economist print edition

AP

More vaccine is needed to prepare the world for an influenza pandemic

IT IS hard to imagine that the aches and pains that most people know as flu could mutate into a superflu that might kill tens of millions of people within two years. And yet, if superflu strikes—as it has done three times in the past century—that is what may well happen. In the global influenza pandemic of 1918, 25m-50m people died. Many scientists now believe that another influenza pandemic is inevitable some time soon.

These concerns might be little more than another background worry if it were not for the fact that there is currently a strain of bird flu in widespread circulation to which humans have no natural immunity. This strain has killed more than 60 people so far, about half the number infected. Small pockets of human-to-human transmission have already been seen, and health officials are worried that the widespread geographical extent of bird flu means that it is not a question of if a strain emerges that can be transmitted easily between humans, but when.

Worried scientists have finally managed to catch the attention of politicians. Last week at the United Nations General Assembly, George Bush announced a new international partnership to address avian and pandemic influenza. World health ministers will meet in Canada next month to discuss how to pool resources, boost surveillance and improve the capacity to contain and respond to an outbreak. The World Health Organisation (WHO) wants more governments to draw up preparedness plans (only 40 have these so far) and agree on how they will co-ordinate their responses.

One leading concern is the scarcity of flu vaccine. Although the WHO's new global stockpile of anti-

viral drugs is a good first line of defence, the only sure way of protecting billions of people against superflu is to vaccinate them. Few people would have natural immunity.

It could also take six months from the appearance of the first superflu strain to produce a vaccine. In that time, large numbers of people would be likely to die. Anti-viral drugs rushed to the location of any outbreak might delay its spread by a month. But, even with such a delay, the world is woefully unprepared for a pandemic. Its entire capacity for flu-vaccine production is only 300m shots a year (each containing 15 micrograms of the active ingredient known as antigen). Yet in the case of superflu, several billion people would need vaccination—and they may need two shots at higher doses.

While most people only need one shot of vaccine against chicken pox or measles to have life-long immunity, flu is different. The vaccine must be produced each year from scratch because, each year, the influenza virus changes.

Vaccines are complicated to produce and prone to hit production problems. To make a flu vaccine, the virus must be grown on fertilised chicken eggs without allowing the growth of any other organisms that might contaminate the product. The eggs must be specially produced to assure the health of the hens and the sanitation of supply.

Reliance on eggs is the rate-limiting step in flu-vaccine production. The eggs take weeks to grow. Then the virus is extracted from the cells it has attacked, and inactivated. When the virus is injected into a subject, it stimulates an immune reaction in the form of antibodies, which would protect that person against the real live version of the virus.

Most of the world's flu vaccine is produced in nine countries: Australia, Britain, Canada, France, Germany, Italy, Japan, the Netherlands and the United States. Europe produces 70% of the vaccines. And Europe's vaccine producers are worried. Without international agreements now, they say there is a high risk of inadequate, inequitable and delayed supplies of vaccines. Among public-health officials and vaccine manufacturers, there is a widespread assumption that, during an outbreak, countries with production facilities would declare a national emergency and limit or ban the export of vaccine to other countries. That might be good for people living in the nine countries on the list, but it would leave the rest of the world without any vaccine at all.

Luc Hessel is the director of public affairs at Sanofi Pasteur, a vaccine manufacturer in France. He is also in charge of pandemic influenza at European Vaccine Manufacturers, the vaccine-industry's trade association. He says that the race to prepare for the next strain of superflu is “both a sprint and a marathon”.

The spread of bird flu has recently forced a bit of strategic sprinting. America's National Institutes of Health has paid Sanofi Pasteur and Chiron, a manufacturer based in Emeryville, California, to make prototype vaccines against H5N1, the strain of bird flu that is currently circulating. Should superflu emerge from this bird flu, the hope is that these vaccines would confer enough resistance against the new strain of superflu to save lives. And having a prototype or a pre-approved vaccine would speed the drug-approval process. In Europe, there is no obvious way of funding such short-term development work. Dr Hessel says that the vaccine industry's association is in “close contact” with the European Commission about plugging this obvious gap.

The American work has already produced some important findings. A vaccine has been developed, and the authorities have ordered small amounts to protect some health workers. The most important finding, though, is that large quantities of antigen—the active ingredient—are needed to confer resistance. For protection, two shots of 90 micrograms are needed. At this concentration, America could protect only 5% of its population.

A novel solution to this problem is emerging from European laboratories. Rino Rappuoli, the chief scientific officer at Chiron, is one of those working on a way to make vaccines protective at low doses by delivering the injection along with something called an adjuvant. This makes the vaccine linger at the site where it has been injected, and causes an enhanced immune response. Dr Rappuoli says that if an adjuvant is used, half the normal flu dose would work. This technique could thus be used to double the world's capacity to produce a superflu vaccine.

Adjuvants also appear to stimulate longer-lasting immunity. In work published earlier this year in the *Journal of Infectious Diseases*, Dr Rappuoli's group studied samples from people involved in a vaccine study after the 1997 outbreak of bird flu in Hong Kong. They found that people who had received adjuvanted vaccine years ago are still significantly immune to the strain of bird flu currently circulating.

The next step is to test a vaccine against H5N1, the current strain of bird flu, with an adjuvant. John Treanor, professor of medicine at the University of Rochester, says that there are three candidate adjuvants. Two are proprietary products (owned by Chiron and GlaxoSmithKline) and so less attractive. The other is alum, a salt containing aluminium. It has been used widely in vaccines, although not in flu vaccines, so development work is needed.

Despite all the promise of adjuvants, some obstacles remain. They can cause mild localised reactions, and they are only licensed for use in flu vaccines in 20 countries, including Italy—where Dr Rappuoli is based and where Chiron has treated 18m people with adjuvanted vaccine. Nevertheless, given their substantial advantages, adjuvants are certainly worth pursuing as a matter of urgency.

Other ideas under scrutiny include ways to use less vaccine at the injection stage, and injecting at different sites to stimulate a greater reaction—such as into the skin itself. But Klaus Stohr, who runs the WHO's global influenza programme, is adamant that the only sure way to answer the unknowns about pandemic influenza is for governments to provide a better environment for flu-vaccine development, and to increase the uptake of seasonal vaccines where this fits in with national health priorities. By this, he means that governments need to buy all of the seasonal vaccine that national health agencies have said would be worthwhile.

It would also help for governments to give the manufacturers more long-term certainty over the amount of vaccine they plan to buy each year. Canada, for example, recently signed a ten-year agreement with a manufacturer for its seasonal vaccine supply, and the country also pays an annual “pandemic readiness fee” which stipulates the company has the capacity to produce 8m doses of vaccine per month for four months.

In the longer term, there will be more options. Flu vaccines could be grown in a vat of cells rather than laboriously in eggs, which would make them easier to produce in volume. And the novel approaches that are today on the drawing board may mean that, one day, neither flu nor superflu would be a problem. Some people are working on a universal vaccine, a shot that is given once and which works for ever against all flu. Others are trying to devise an inhaled drug that coats the cells of the lungs and prevents the virus from gaining access. But this is the work of the superflu marathon runners. Before they reach the finishing line, the sprinters may be called upon.

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Space exploration

Shooting for the moon

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From The Economist print edition

NASA plans a new architecture to support human spaceflight

Get article background

THERE is something suspiciously precise about a cost estimate of $104 billion for any project. And scepticism is appropriate when this sum is the result of four months' work by NASA, America's space agency, on a project dubbed the 60-day study.

Nevertheless, NASA's new plans for a return to the moon manage to please a surprisingly large constituency. By 2018, NASA wants to be able to land on the moon for seven-day visits and prepare for longer stays. By 2010, it also needs to have a successor to the shuttle, or one almost ready to fly. Plus, it would rather like the private sector to offer a cheaper way of delivering cargo to the International Space Station than the deal it gets from its current overfed contractors. Oh, and it would really rather like to go to Mars, someday, if at all possible.

The key to all of this is to have not one new vehicle but two. The first is an *Apollo*-like ship called the Crew Launch Vehicle (CLV) that can transport up to six crew to and from the space station, and which could conceivably be docked to the station as an emergency life raft. But this craft could also dock in orbit with a separately launched crew exploration vehicle (CEV) that contains propulsion to go to the moon and a lunar lander. NASA says it can do all of this on its annual budget.

Launching the craft using shuttle-derived components will save money. The CEV would have to be launched by a heavy-lift vehicle but this could also take cargo to the space station, or bits into orbit for a Mars shot. And launching the crew will be safer than using the shuttle because astronauts will sit above the rocket, avoiding falling foam.

With all the shuttle-derived components, NASA can keep most of its facilities open (and the politicians happy). Finally, the NASA administrator, Mike Griffin, has even thrown a small bone to the private sector. He says the structure “allows” the cargo ship to “stand down” from supplying the station. The only rabbit Dr Griffin has not pulled out of the hat is to explain how he can afford to build the CLV while keeping the shuttle going. He probably didn't want to spoil the fun this week by explaining that he will have to cancel many of the remaining shuttle missions. And how will America send astronauts to the space station before the shuttle's replacement is available? It is surely no coincidence that NASA is now going to be allowed to buy more Russian-made *Soyuz*—even though the terms of the Iran Non-Proliferation Act presently forbid the agency from doing so.

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Economist.com SCIENCE & TECHNOLOGY

Scientific publishing

The paperless library

Sep 22nd 2005
From The Economist print edition

Free access to scientific results is changing research practices

IT USED to be so straightforward. A team of researchers working together in the laboratory would submit the results of their research to a journal. A journal editor would then remove the authors' names and affiliations from the paper and send it to their peers for review. Depending on the comments received, the editor would accept the paper for publication or decline it. Copyright rested with the journal publisher, and researchers seeking knowledge of the results would have to subscribe to the journal.

No longer. The internet—and pressure from funding agencies, who are questioning why commercial publishers are making money from government-funded research by restricting access to it—is making free access to scientific results a reality. This week, the Organisation for Economic Co-operation and Development (OECD) issued a report describing the far-reaching consequences of this. The report, by John Houghton of Victoria University in Australia and Graham Vickery of the OECD, makes heavy reading for publishers who have, so far, made handsome profits. But it goes further than that. It signals a change in what has, until now, been a key element of scientific endeavour.

The value of knowledge and the return on the public investment in research depends, in part, upon wide distribution and ready access. It is big business. In America, the core scientific publishing market is estimated at between $7 billion and $11 billion. The International Association of Scientific, Technical and Medical Publishers says that there are more than 2,000 publishers worldwide specialising in these subjects. They publish more than 1.2m articles each year in some 16,000 journals.

This is now changing. According to the OECD report, some 75% of scholarly journals are now online. Entirely new business models are emerging; three main ones were identified by the report's authors. There is the so-called big deal, where institutional subscribers pay for access to a collection of online journal titles through site-licensing agreements. There is open-access publishing, typically supported by asking the author (or his employer) to pay for the paper to be published. Finally, there are open-access archives, where organisations such as universities or international laboratories support institutional repositories. Other models exist that are hybrids of these three, such as delayed open-access, where journals allow only subscribers to read a paper for the first six months, before making it freely available to everyone who wishes to see it.

All this could change the traditional form of the peer-review process, at least for the publication of papers. The process is organised by the publisher but conducted, for free, by scholars. The advantages afforded by the internet mean that primary data is becoming available freely online. Indeed, quite often the online paper has a direct link to it. This means that reported findings are more readily replicable and checkable by other teams of researchers. Moreover, online publication offers the opportunity for others to comment on the research. Research is also becoming more collaborative so that, before they have been finalised, papers have been reviewed by several authors. This central tenet of scholarly publishing is changing, too.

Economist.com SCIENCE & TECHNOLOGY

Exercise and the elderly

Circuit training

Sep 22nd 2005
From The Economist print edition

Exercise boosts mental powers, even after a mis-spent youth and middle age

IT IS never too late for the lazy and the old to get off their haunches and exercise. This week, a study found that physical activity beginning in old age, even after a whole life lost to sloth, can help rescue the brain from mental decline—at least in mice.

The link between taking exercise and remaining mentally astute into the golden years is well known but not well understood. Exercise seems to stimulate the growth of new neurons in certain parts of the brain. Physically active animals (including humans) perform better on tests of cognition than their inactive counterparts. But the assumption was that, at some point, people might be past salvaging.

Perhaps not. Fred (“Rusty”) Gage and his team at the Salk Institute in La Jolla, California, studied young and old adult mice. Half the mice were given running wheels, on which they happily ran five or six kilometres a day. The other half were denied the opportunity to exercise.

Some 35 days later, each mouse was plopped into a tub of milky water. This water also contained a refuge, in the form of a hidden platform that was underwater but which the mice could stand on. Mice hate swimming, so they quickly learn to use visual cues to remember where the platform is (even when the scientists move the platforms and the cues around a few times). The test is about how quickly the mice can learn and remember the whereabouts of the platform.

It turns out that how quickly they learn and remember in old age is strongly associated with how much they had been exercising. Both groups of elderly mice swam at about the same pace, so the time it took to find refuge was not about improved swim speed. Yet whereas the physically fit old-timers found the platform in about 15 seconds, the old sedentary ones took 30 seconds—twice as long. (As for the young mice, it is a sad reality that youth gets away with a lot. Even the young sloths could remember where the platform was in less than 15 seconds.)

The difference in performance may come down to what was going on in the mice's brains. About a week after the water test, the mice were killed and the researchers examined their brains, counting the numbers of new neurons. In the elderly exercisers, about 26% of new brain cells were developing into neurons—not as large a proportion as in the younger mice, to be sure, but significantly more than the 9.5% in their non-running counterparts.

The team also found that, under the microscope, the neurons looked just like those developing in younger brains, suggesting they were working properly. There had been some suggestion that perhaps older brains simply lost their capacity for neurogenesis, but Dr Gage (who exercises daily) says this study demonstrates otherwise. And, although it is not clear that the new neurons are responsible for the improved performance, the evidence certainly points in that direction. The team published their work earlier this week in the *Journal of Neuroscience*.

Although this work was carried out using mice, it has been shown that humans, like many other

animals, can grow new neurons even as adults. (Indeed, this was first demonstrated in Dr Gage's laboratory.) The implications for people, therefore, may prove to be rather straightforward: exercise may fight the ravages of age not just on your jowls and thighs and gut, but in your mind as well.

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Astronomy

Starry, starry night

Sep 22nd 2005
From The Economist print edition

Twirls and swirls from outer space

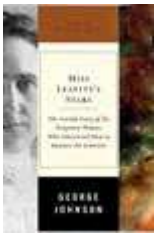
SCIENTIFIC cosmology is a tale of three stupendous realisations: the Earth is one of many planets, the sun is one of myriad stars and the Milky Way is just one of countless galaxies. The last of these mental expansions occurred in the early 1920s, and it hinged upon an earlier discovery that was made by a computer—not a machine, but a woman.

In 1895 Henrietta Leavitt became part of a team of women who were employed as “computers” by the Harvard College Observatory. For $0.25 an hour, the computers (they were actually called this) pored over photographs of the sky, counting and classifying thousands of stars. One observatory director, Harlow Shapley, actually measured a project's difficulty by the number of “girl-hours” required. Yet out of this tedium came forth crucial data for Harvard astronomers.

The greatest astronomical mystery of the day concerned the lovely spirals that astronomers saw through their telescopes. Were these merely gas clouds within the Milky Way, or entire galaxies viewed from afar? Reckoning distance is the toughest problem in astronomy. From Earth, a distant, luminous star looks just the same as a feeble yet closer star. Knowing whether a star is intrinsically luminous or feeble makes it possible to calculate how far away it is.

Henrietta's hours were spent finding stars that vary in brightness. In “Miss

Miss Leavitt's Stars: The Untold Story of the Woman Who Discovered How to Measure the Universe
By George Johnson



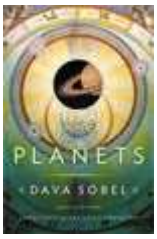
Norton; 162 pages; $22.95.
Weidenfeld &Nicolson; £14.99

Buy it at
Amazon.com
Amazon.co.uk

The Planets

Leavitt's Stars", George Johnson artfully tells how this seemingly obscure research led to a drastic revision in the perceived size of the universe. Certain rare stars, known as Cepheids, grow brighter and fainter at a regular rate. Miss Leavitt found that the rate depends on the star's total light output (luminous Cepheids pulse more slowly than feeble ones) a discovery that allows them to be used for cosmic surveying. In 1924, Edwin Hubble, the former lawyer who became the father of modern astronomy, discovered Cepheids in one of the mysterious spirals, Andromeda, proving it to be unimaginably distant and enormous—an "island universe" in itself.

By Dava Sobel



Viking; 288 pages; $24.95.
Fourth Estate; £15

Buy it at
Amazon.com
Amazon.co.uk

In addition, Miss Leavitt discovered around 2,400 Cepheids, about half of those known in her day. Astronomers still adore Cepheids. Finding them in ever-more-distant galaxies was a primary reason for building the Hubble space telescope. But Miss Leavitt never cashed in on her momentous discovery. She spent the following decade on far less interesting assignments, and then she died.

In potted histories, Miss Leavitt's story is often shaped into that of the female who was thwarted by her egotistical male superiors. Mr Johnson does not take this easy path. Instead, he has searched primary sources—letters, diaries and town records—in an effort to become acquainted with Miss Leavitt herself.

Unfortunately, there is little to reveal her true ambitions. Miss Leavitt comes across as a sort of wraith—humourless and often ill, and rumoured to haunt the observatory after her death. In contrast, enough is known of Shapley, her last boss, to be sure of his egotism. Shapley saw evidence for Cepheids in Andromeda long before Hubble did, but refused to believe they could be Cepheids out of a stubborn attachment to his own theories.

Mr Johnson's work will surely be compared with "Longitude", Dava Sobel's eye-opening account of the invention of accurate timepieces, which came out in 1996 and which launched the literary genre of science micro-history. "Miss Leavitt's Stars" is unlikely to sell as many copies, but it is nearly as deserving.

Meanwhile, Ms Sobel has broken away from the genre she began and written a different sort of book. "The Planets" is a "love letter to the solar system", according to its advertising blurb; each chapter being an essay about a planet or some other aspect of the cosmic neighbourhood.

At her best, Ms Sobel blends together anecdote, science and history in a confection of elegant prose. In her chapter on the moon, she recounts how a friend of hers received a mote of moondust as a gift from a suitor who worked in a lunar research lab. Thus begins a meditation on the *Apollo* programme, the dryness of lunar soil and the rhythm of tides.

In this case, the inevitable comparison is to Diane Ackerman's 1990 book, "A Natural History of the Senses". Unfortunately, Ms Sobel's essays are a little hit-and-miss. One relates the history of the exploration of Mars from the point of view of a Martian meteorite. How this rock acquired omniscience and why its voice is exactly like Ms Sobel's remain unclear. Another chapter is a pretend letter from Caroline Herschel (another under-appreciated female astronomer of yore) who dishes out capital letters and exclamation marks like an over-eager e-mailer. It is hard to know what to make of the chapter on astrology, superstition that Ms Sobel appears to take seriously, and which shifts the tone of her book from thoughtful to flaky.

This is a pity. At a time when rovers are exploring Mars, a satellite is looping around Saturn's rings and a body larger than Pluto was recently found in the far reaches of the solar system, the reader who wants to catch up on developments could have done with a book of more uniform quality.

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By George Johnson.
Norton; 162 pages; £22.95.
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The Planets.
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Fourth Estate; £15

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Doing business in China

Brick wall

Sep 22nd 2005 | HONG KONG
From The Economist print edition

JAMES McGREGOR'S “One Billion Customers” is the latest in a small but important collection of books for the business executive venturing into China in search of riches—and for the boss at headquarters who cannot fathom why his or her China manager, after years, is still making losses.

One Billion Customers: Lessons from the Front Lines of Doing Business in China
By James McGregor

Free Press; 336 pages; $27
To be published in Britain by Nicholas Brealey in December

Buy it at
Amazon.com
Amazon.co.uk

Like “The China Dream” by Joe Studwell and Tim Clissold's “Mr China”, or even Tom Doctoroff's “Billions”, which comes out in America next January, Mr McGregor uses real-life cases to draw some important conclusions. How (not) to deal with local partners is illustrated by Morgan Stanley's pioneering, if unsuccessful, joint-venture to set up China's first domestic investment bank. The moral, says Mr McGregor, who has spent nearly two decades in China, first as a *Wall Street Journal* correspondent and then as China business head for its parent Dow Jones, before becoming a venture capitalist and consultant, is to avoid joint-ventures with government entities and never to forget that the person who hires your staff can make or break your business.

Similarly, a battle between Dow Jones and Reuters and China's Xinhua news agency in the mid-1990s, over the rights to broadcast financial information, proved that a big Chinese bureaucracy can sometimes be beaten. This example also highlights how foreigners have to battle with everyone from regulators to their joint-venture partners. One tactic is to “play the dumb foreigner—tie your opponents in knots by asking detailed questions about how the system works” and use the fact that “most Chinese government officials live in fear of being criticised for not upholding China's interests.”

Finally, “don't rely exclusively on the law...you will lose.” For those thinking they can protect their intellectual property, there is the tale of technology companies such as McDonnell Douglas and Hughes Electronics. How Rupert Murdoch turned from foe to friend in the eyes of China's leaders is also there, and is a salutary lesson. Notwithstanding the fact that the Chinese recognised a kindred spirit in the media mogul—his opaque, family-run News Corporation reminded them of one of their own state firms—Mr Murdoch has found China tough going.

Mr McGregor makes sweeping generalisations. His readers may be so desperate to “crack” China, that they are prepared to overlook this. But the author might have punched even harder had he concentrated solely on the few recurring themes that are critical to understanding China, though these do eventually emerge. One is that “the overall system is almost incompatible with honesty.” Assume that all procurement departments are corrupt, that suppliers need to be told not to bribe and that technology firms will always be ripped off. Another expectation is that you will always be cheated. Business is about survival: “for someone to win, somebody has to lose.” Very apparent also is China's eagerness to become a world-class competitor and its paranoia and insecurity about the outside world. The result is often a power struggle. “The Chinese always need to get

concessions from you," Mr McGregor writes, and will try to cast you as being "unfriendly" to China if you don't give them what they want. They will push an unfair deal on you because they think you will do anything to operate in China, and will ask for things "because you just may be stupid enough to agree".

Mr McGregor stamps on the notion that *guanxi* (connections) are the key to success, calling the concept: "overrated, temporary and non-transferable. Never ever put your business in the position where you are dependent on one individual for access to government officials." He tempers western enthusiasm for China's human capital. The Chinese like to be guided by formulae and charismatic leaders, but prefer not to think creatively or take responsibility for decisions. The rote education system "leaves many weak on powers of analysis and leadership". "What are the four most troubling words in a Chinese company? 'Up to you boss'." Finally there is the importance of patience: "If your boss wants to do a quick deal in China," advises Mr McGregor, "lose his or her visa".

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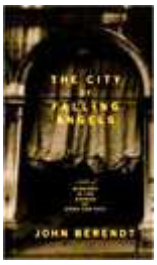
Venice

Sink and swim

Sep 22nd 2005
From The Economist print edition

JOHN BERENDT has done for Venice and Venetians what he did for Savannah, Georgia, in his book with the beguiling title, “Midnight in the Garden of Good and Evil”. Again, Mr Berendt uses a crime, in this case arson at the Fenice Theatre in 1996, to provide a strong narrative line, which is regularly interrupted by episodes of venality, vanity, snobbery and family feuding.

The City of Falling Angels
By John Berendt



Penguin Press; 372 pages; $25.95.
Sceptre; £20

Buy it at
Amazon.com
Amazon.co.uk

The style belongs to the New Journalism, as practised in *Esquire* and *New York* magazine; he worked for both. As Mr Berendt deploys it, highly coloured gossip takes precedence over verifiable fact. But the reading is easy, and the sales will no doubt be gratifying, although it will be hard for this second book to emulate the first, which sat for four years on the *New York Times* bestseller list.

For tourists, Venice is a dazzling monument to the past, especially to the economic power and artistic patronage of the Renaissance. For Venetians now, it is a small town (population 70,000) where there is not much to do, and always the same people to do not much with. This is a fertile breeding ground for something dear to Venetian hearts: conspiracy theories that feed on gossip and cynicism about other people's motives.

Mr Berendt has breathed deeply the air of the city of falling angels—the title comes from a sign on the steps of the Salute church in the early 1970s, when Venice seemed to be crumbling. He describes the Fenice fire, and the subsequent investigation that led to the conviction for arson of two electricians. He does this well, but he goes further, speculating that the electricians were “surrogates for others who remained in the shadows”. Like most Venetians, he takes nothing at face value.

Mr Berendt investigates the transfer to Yale University of important Ezra Pound papers, in the possession of Olga Rudge, Pound's former mistress who lived in Venice. In telling the story, he suggests that two prominent members of the English community in Venice, Philip Rylands, the director of the Peggy Guggenheim collection, and his wife Jane, might have acted against Rudge's best interests, and that they have been secretive. However, proof of their wickedness appears to stubbornly evade Mr Berendt.

The author thrives on conflict as well as conspiracy, and his account of a melodramatic struggle for power in Save Venice Inc, one of the fund-raising organisations that have done much to restore the stones of Venice, is splendidly entertaining and thoroughly damaging to all parties. This may be because for once he was conducting his research mainly in English; his Italian being, he says, only “passable”. This suggests that his accounts of lengthy conversations with Venetians may be somewhat contrived, if that does not sound too cynical.

Mr Berendt writes: “I knew in Venice I had been told truths, half-truths, and outright lies, and I was never entirely sure which was which.” He does not appear troubled by this. A broad-brush approach can be a good route for a reporter to the bestseller list, but it is difficult not also to feel a bat-squeak of sympathy for his victims. Whether it was his intention or not, Mr Berendt exposes Venice as a self-absorbed and heartless city.

The City of Falling Angels
By John Berendt
Penguin Press; 372 pages; $25.95.
Sceptre; £20

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Economist.com BOOKS & ARTS

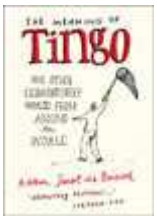
Words

Meaning and life

Sep 22nd 2005
From The Economist print edition

EAGLE-EYED publishers will have noticed a discernible trend in contemporary Christmas stockings: that the pot pourri of little bits of coal, tangerines, chocolate coins and other semi-useless items should also include a small book that fits neatly into one's handbag or above the cistern. Not only is this trend infinitely self-improving, but it has resulted in dramatic sales figures for items such as “Schott's Miscellany” and “Eats, Shoots and Leaves”, both of which spent many pre- and post-Christmas weeks on the bestseller list in recent years. “The Meaning of Tingo” may well prove to be the must-have British stocking-filler for 2005.

The Meaning of Tingo and Other Extraordinary Words from Around the World
By Adam Jacot de Boinod



Penguin; 209 pages; £10. To be published in America by Penguin Press in March

Buy it at Amazon.co.uk

Adam Jacot de Boinod, a BBC researcher, has sifted through more than 2m words in 280 dictionaries and 140 websites to discover that Albanians have 27 words for moustache—including *mustaqe madh* for bushy and *mustaqe posht* for one which droops down at both ends—that *gin* is Phrygian for drying out, that the Dutch say *plimpplampppletteren* when they are skimming stones and that instead of snap, crackle, pop, Rice Krispies in the Netherlands go *Knisper! Knasper! Knusper!*

English has a tendency to absorb foreign words and then neutralise them—ad hoc, feng shui, croissant and kindergarten are all good examples—which may be why English-speakers often fail to realise quite how wonderfully subtle and evocative other tongues can be.

It is not so much the languages that have two dozen words for snow, say, or horse or walrus carcass that impress the most, but those that draw differences between the seemingly indistinguishable. Italian, as one would imagine, is particularly good on male vanity, and French on love as a business. The richness of Yiddish for insults seems to be matched only by the many and varied Japanese words for the deep joy that can come as a response to beauty and the German varieties of sadness and disappointment.

Words for work, money, sex, death and horrible personal habits may well tell you more about national attitudes than anything else. Why would Russian have a special word, *koshatnik*, for someone who deals in stolen cats and Turkish another, *cigerci*, for a seller of liver and lungs, or Central American Spanish a particular name, *aviador*, for a government employee who shows up only on payday?

Old jokes are often the best jokes, and many of the most amusing examples are of terrible errors that can be made in different languages: there is *fart* (Turkish for talking nonsense), *buzz* (Arabic for nipple), *sofa* (Icelandic for sleep), *shagit* (Albanian for crawling on your belly), *jam* (Mongolian for road), *nob* (Wolof for love), *dad* (Albanian for babysitter), *loo* (Fulani for a storage pot), *babe* (SisSwati for a government minister), *slug* (Gaulish for servant), *flab* (Gaelic for a mushroom) and *moron* (Welsh for carrot).

Not that *The Economist* does not occasionally face linguistic problems: a cover story entitled “The meaning of Lula” (see article) in October 2002 resulted in a huge mailbag, not from Brazilians who were impressed at our analysis of the recent election, but from Pakistanis eager to tell us that the meaning of *lula* in Urdu is penis.

This book is a gem, and there are still 91 shopping days till Christmas.

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By Adam Jacot de Boinod.
Penguin; 209 pages; £10. To be published in America by Penguin Press in March

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Economist.com BOOKS & ARTS

London theatre

Hidden secrets

Sep 22nd 2005
From The Economist print edition

Mike Leigh at the theatre—again

Hopeless

AS THEATRICAL mysteries go, London has this month been playing to quite a potent enigma, which has nothing to do with such ostensible thrillers as “The Mousetrap” and “The Woman In Black”, both somehow still entrenched on the West End stage. Far greater suspense has been hovering over “Two Thousand Years”, the first play in 12 years from Mike Leigh, a British film-maker, and his first-ever staging for the National Theatre. The entire London run sold out within days, even though the play did not even have a name until a fortnight before its premiere. Now that the finished result has finally been unveiled, one can appreciate a script that is full of its creator's characteristic social engagement and compassion even if, in various crucial ways, the play seems unfinished still.

Ever since his last show, “It's A Great Big Shame”, played at the Theatre Royal, Stratford East, in 1993, Mr Leigh has gone on to become one of the big names in British cinema, racking up accolades, prizes and many an Oscar nomination for such movies as “Secrets & Lies”, “Topsy-Turvy” and, most recently, “Vera Drake”. But “Two Thousand Years” is a reminder that his method of working remains singular, whether on stage or screen. With this play, Mr Leigh yet again began with a set of actors but without a script, thrashing out a narrative in conjunction with his cast across a surprisingly long rehearsal process lasting 18 weeks. (The cast rehearsed outside the building, so not even National employees knew what he was up to.)

Writing for the first time specifically about Judaism, the writer-director, himself a Jew, gives us

three generations in a secular Jewish household in Cricklewood, north-west London. Danny (Allan Corduner), a dentist with a definable gift for Jewish jokes, and his loving wife Rachel (Caroline Gruber), who was born on an Israeli kibbutz, are jolted out of their *Guardian*-reading daily routine by the shift toward religion of their layabout son, Josh (Ben Caplan), a 28-year-old maths graduate who still lives at home. “It's like having a Muslim in the house,” we're told of an incipient orthodoxy that is visualised in highly charged terms: an early scene finds Josh, alone, looking as if he is about to inject heroin into his arm when he is, in fact, donning the *tefillin* that are part of Jewish prayer.

What makes Josh tick? The play doesn't say, which leaves Mr Caplan having to spend much of the show skulking about the stage until a climactic change of devotional heart that arrives out of the blue. Meanwhile, the household is alive with chatter, much of it about current events. In the course of the year or so that is covered by the narrative, we get passing nods to the Israeli withdrawal from Gaza, Tony Blair's historic third-term election, the rise of the British National Party, and a recent hit film, “Crash”. Disillusionment with modern Israel chimes with a larger, lingering dystopia. As Danny matter-of-factly puts it: “Maybe we've all lost hope.”

Thematically, the play would seem to be of a piece with numerous other British dramas about idealism gone sour. (For a supreme example of the genre, see Michael Frayn's “Benefactors”.) But the problem with “Two Thousand Years” is that, for all its keen observations of the fissures that attend most families, the play has too little pulse.

It's fine to want to catch life on the wing, as Mr Leigh does with exhilarating ease in his best works. But at least one crucial character, Rachel's careerist younger sister, Michelle (played by a manic Samantha Spiro), gets airlifted into the plot with a cartoonish thud well into the second act in a way that runs counter to Mr Leigh and his normally organic approach.

“Two Thousand Years” accordingly, does impress in parts. What is missing is the cumulative impact that should be expected from the theatre when life, in all its minutely observed detail, is transformed into art.

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Family memoirs

Branches entwined

Sep 22nd 2005
From The Economist print edition

THE two lives of Vikram Seth's new book are those of his great uncle and aunt, Shanti and Henny; an Indian and German-Jew whose lives were buffeted and shaped by the upheavals of migration, oppression and war. Mr Seth follows them from early 20th-century India to Germany and finally to England where, displaced from the cultures of their respective homelands, they come to embrace a third one together, that of the British middle class.

Two Lives
By Vikram Seth

To be published in America by HarperCollins in October
Little, Brown; 503 pages; £20.

Buy it at
Amazon.com
Amazon.co.uk

Out of this emerges a subtle portrait of the complexities of a long companionship based on confidences rather than mutual confidence. For Henny, Shanti was the sole link to her past life in Berlin, a city that she was never to revisit. She wrote that they married “because of his sympathy with what I have inwardly gone through and what will never again be erased”. Yet she never spoke to him of her grief or loss, or shared in his extended Indian family.

His affection for her is visible in the letters he writes from the war front, but Shanti had to reconcile himself to a relationship in which there were rooms that were closed off. The glue that bound them is reminiscent of what Erich Fromm terms “love as a social and not only exceptional-individual phenomenon”. In this sense “Two Lives” is about two loves in a single marriage.

If, as Ernest Hemingway wrote, prose is architecture, then this memoir-cum-biography houses its characters in a way that allows readers to look in without feeling that they are gawping. Mr Seth is a sensitive, intelligent man. He combines an attention to detail and a willingness to let the source material speak for itself—most chillingly the banal documentation detailing Henny's family's deportation to the concentration camps. He acknowledges the difficulties that face the historian, but is cautious in his use of conjecture, deploying it always with a grace and lightness that gently prise meaning from otherwise incomplete and unyielding evidence. It is this ability and willingness to act as a vehicle for events both personal and historic that make this such a wonderful book.

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Obituary

Simon Wiesenthal

Sep 22nd 2005
From The Economist print edition

Eyevine

Simon Wiesenthal, Nazi-hunter, died on September 20th, aged 96

ONE of the stranger conversations in Simon Wiesenthal's life occurred in September 1944. He was being taken by SS guards, in his faded striped uniform, away from the advancing Russians. Somewhere in the middle of Poland, he and an SS corporal scavenged together for potatoes. What, the corporal asked him mockingly, would he tell someone in America about the death camps? Mr Wiesenthal said he would tell the truth. “They wouldn't believe you,” the corporal replied.

Not many months later, Mr Wiesenthal was released from Mauthausen concentration camp. “The day was sunny”, he wrote later, “with a scent of spring in the air. Gone was the sweetish smell of burnt flesh that always hovered over the yard.” He saw an American tank, with a white star, advancing; he touched the star, and fainted. He weighed 99 pounds. But even at that extremity, he had not forgotten his exchange with the corporal. His duty now, he reasoned, was to ensure that future generations knew about the Holocaust.

In the years after his release, he helped track down more than 1,100 Nazis. From his Jewish Documentation Centre, a cramped office stacked high with papers in a shabby part of Vienna, he amassed information on war criminals from contacts round the world. One of his greatest triumphs was the discovery of Adolf Eichmann, the mastermind of the Holocaust. Eichmann was bundled out of Argentina in a carpet in 1960, stood trial in Jerusalem and was executed. When the judge asked him if he pleaded guilty, Mr Wiesenthal pointed out that the same question ought to have been put six million times.

He was a clever detective with an elephantine memory. Such skills were needed to unearth the many former Nazis living unremarkable lives in hiding. Hermine Braunsteiner, for example, had emigrated to America in the 1950s, married a building worker and moved to Queens, in New York. Neighbours thought her “the nicest woman in the street”. Yet as a concentration camp guard she would shoot small children and select women for the gas chambers. In 1980, after Mr Wiesenthal unmasked her, she was sentenced to life imprisonment by a German court.

Mr Wiesenthal pursued his other goal—reminding the world about the dangers of Nazism—with equal determination. He lectured, wrote books and appeared on television. He would issue warnings about trends in far-right politics, and remind world leaders of their duty to combat racism. Because of his fame, politicians would at least pretend to listen.

Inevitably he made enemies. Far-right groups regularly threatened to kill him and denounced him as a murderer and a liar. In 1982, neo-Nazis blew up his house. More moderate critics thought he was driven purely by revenge. But Mr Wiesenthal never sought to punish war criminals personally. He wanted prosecutions in legitimate courts of law, and only if the case was watertight. He refused to condemn Kurt Waldheim, Austria's president, as a war criminal, insisting there was insufficient evidence. He also argued that John Demjanjuk, who was accused of being a camp guard known as “Ivan the Terrible”, should be set free when an Israeli court could not nail him. Too many people, he explained, “are waiting for the Jews to accuse somebody without evidence.”

A Cossack sabre

Not long after the war, a sort of moral weariness set in. The cold war distracted both America and the Soviet Union from prosecuting Nazis, and most camp survivors immersed themselves in re-making their ordinary lives. Mr Wiesenthal, too, might have given up, and returned to his profession of building villas for businessmen.

He refused to relent because of what he had suffered, before the war as well as during it. His early life in Buczacz, on the eastern edge of the Austro-Hungarian empire, was one of everyday persecution. A scar on his thigh came from a Cossack sabre that slashed him as he crossed the street, at the age of ten, to borrow yeast from a neighbour. He had to go to Prague to study architecture because the Polytechnic at Lvov enforced a Jew-quota. The partition of Poland in 1939, which brought a Russian purge of Jewish professionals, forced him to close his architectural practice. In 1941 he stood in a row of men who were being shot in the neck, one by one, by a Ukrainian policeman. He was saved by the ringing of the bell for evening mass.

The Final Solution claimed 89 members of Mr Wiesenthal's family, including his mother. Helpless, he watched her being packed into a stifling goods train for Belzec. He himself was transferred between 12 different concentration camps. During his four years of internment he twice attempted suicide, twice tried to escape and was twice chosen for immediate execution. His wife Cyla, so he believed, had been killed during the Warsaw uprising of 1944, when her street had become a mass grave. His one consolation at the end of the war was to be reunited with her.

The only way Mr Wiesenthal could live with such memories was to hunt Nazis. He argued that his survival of the Holocaust gave him a duty to seek justice for the millions who had died. Judgment and reckoning could not be left, as Christians might believe, to God. Only forgiveness was properly left to Him.

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Overview

Sep 22nd 2005
From The Economist print edition

America's Federal Reserve raised short-term interest rates by a quarter of a percentage point for the 11th consecutive time, to 3.75%. The policy-setting committee warned of higher and more volatile energy prices in the future, but doubted that the damage wrought by Hurricane Katrina would be a “persistent threat” to the economy.

Consumer prices in **America** increased by 0.5% in August, pushing the year-on-year rate to 3.6%. Analysts expect that Hurricane Katrina's full impact on energy prices will be reflected in September's figures. Meanwhile, the Philadelphia Fed's index of manufacturing activity slipped from 17.5 in August to 2.2 in September. The current-account deficit narrowed slightly in the second quarter to 6.3% of GDP, compared with 6.5% in the first quarter.

Germany's stockmarket slid after the country's general election failed to produce a clear winner. In the first trading day after the election, the benchmark DAX index fell by 2.3%, but then recovered slightly. The ZEW index of economic sentiment fell sharply to 38.6 in September from 50.0 in August, almost completely reversing the gains in the previous month.

French consumer spending rose briskly over the summer, increasing by 1.2% in July and by 1.9% in August, driven mostly by clothing and household equipment.

Industrial production in the **euro area** expanded by 0.2% in July, driven mainly by strong growth in Germany. The rate of increase in hourly labour costs in the euro area fell by more than expected in the second quarter, to 2.3%, compared with 3.0% in the first quarter, easing concerns about inflation. The euro-area's current-account surplus narrowed to $10.3 billion in the 12 months to July—its smallest for more than three years.

Households in **Japan** are becoming more optimistic. The consumer-sentiment index rose slightly to 48.4 in August from 48.2 in July, lifted by better job prospects and rising wages.

The **Bank of England's** rate-setting committee voted unanimously to keep interest rates steady at 4.5%, according to the minutes of its September meeting. British retail sales grew by only 0.8% in the year to August, down from almost 7% a year earlier.

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Output, demand and jobs

Sep 22nd 2005
From The Economist print edition

% change on year ago

	GDP			The Economist poll GDP forecasts		Industrial production		Retail sales (volume)		Unemployment % rate		
	latest		qtr*	2005	2006	latest		latest		latest		year ago
Australia	+ 2.6	Q2	+ 5.2	+ 2.4	+ 3.2	+ 1.2	Q1	+ 1.6	Q2	5.0	Aug	5.7
Austria	+ 2.0	Q1	+ 0.8	+ 1.9	+ 2.0	+ 5.8	Jun	+ 1.7	Jun	5.2	Aug	4.9
Belgium	+ 1.5	Q2	+ 1.2	+ 1.2	+ 1.9	– 4.0	Jul	+ 5.9	Jun	13.5	Aug†	13.2
Britain	+ 1.7	Q2	+ 1.5	+ 2.0	+ 2.2	– 1.6	Jul	+ 0.8	Aug	4.7	Jul††	4.7
Canada	+ 2.7	Q2	+ 3.2	+ 2.8	+ 3.0	+ 0.4	Jun	+ 5.9	Jun	6.8	Aug	7.1
Denmark	+ 0.8	Q1	+ 0.6	+ 2.0	+ 2.2	– 1.6	Jul	+ 6.1	Jul	5.8	Jul	6.2
France	+ 1.2	Q2	+ 0.4	+ 1.4	+ 1.8	– 0.7	Jul	– 1.2	Jul	9.9	Jul	10.0
Germany	+ 0.6	Q2	nil	+ 0.9	+ 1.3	+ 3.0	Jul	– 3.0	Jul	11.6	Aug§	10.6
Italy	+ 0.1	Q2	+ 2.8	– 0.2	+ 1.0	– 0.9	Jul	– 1.5	Jun	7.8	Mar	8.2
Japan	+ 1.4	Q2	+ 3.3	+ 1.9	+ 1.9	– 2.2	Jul	+ 3.6	Jun	4.4	Jul	4.9
Netherlands	+ 1.3	Q2	+ 4.9	+ 0.5	+ 1.6	+ 0.1	Jul	+ 1.2	Jun	6.6	Aug**	6.2
Spain	+ 3.4	Q2	+ 3.6	+ 3.2	+ 2.8	– 3.5	Jul	+ 0.4	Jul	9.4	Jul	10.9
Sweden	+ 2.2	Q2	+ 2.4	+ 2.1	+ 2.7	+ 7.8	Jul	+ 8.6	Jul	6.5	Aug†	5.5
Switzerland	+ 1.0	Q2	+ 1.1	+ 0.8	+ 1.5	+ 3.9	Q2	+ 1.6	Jul	3.6	Aug†	3.7
United States	+ 3.6	Q2	+ 3.3	+ 3.7	+ 3.3	+ 3.1	Aug	+ 7.5	Jul	4.9	Aug	5.4
Euro area	+ 1.1	Q2	+ 1.2	+ 1.3	+ 1.7	+ 0.5	Jul	nil	Jul	8.6	Jul	8.9
MORE COUNTRIES	Data for the countries below are not provided in printed editions of *The Economist*											
Finland	+ 0.2	Q2	– 6.3	na	na	+ 0.7	Jul	+ 5.4	Jul	7.2	Aug†	8.0
Greece	+ 3.7	Q2	na	na	na	– 4.5	Jul	+ 3.9	Jun	9.9	Mar	10.8
Iceland	+ 6.8	Q2	na	na	na	na		na		2.0	Jul†	3.0
Ireland	+ 2.4	Q1	+ 1.0	na	na	– 3.2	Jul	+ 4.9	Jul	4.3	Aug	4.4
Luxembourg	+ 3.1	Q1	na	na	na	– 1.5	Jun	– 1.4	Jul	4.4	Jul	4.0
New Zealand	+ 1.9	Q1	+ 1.5	na	na	+ 3.5	Q4	+ 5.9	Q2	3.7	Q2	4.0
Norway	+ 4.8	Q2	+ 5.2	na	na	– 1.3	Jul	+ 7.3	Jul	4.7	Jul‡	4.5
Portugal	+ 0.5	Q2	+ 4.1	na	na	– 0.8	Jul	– 1.9	Jul	7.2	Q2†	6.3

*% change on previous quarter at an annual rate. †Not seasonally adjusted. ††May-Jul; claimant count rate 2.8% in Aug. §EU harmonised rate 9.0% in Jul. **Jun-Aug.

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Prices and wages

Sep 22nd 2005
From The Economist print edition

% change on year ago

	Consumer prices		The Economist poll consumer prices forecast		Producer prices		Wages/earnings	
	latest	year ago	2005	2006	latest	year ago	latest	year ago
Australia	+ 2.5 Q2	+ 2.5	+ 2.7	+ 2.7	+ 6.9 Q2	+ 2.8	+ 5.8 Q2	+ 3.0
Austria	+ 2.0 Aug	+ 2.3	+ 2.1	+ 1.8	+ 0.9 Aug	+ 6.3	+ 2.3 Aug	+ 2.0
Belgium	+ 3.1 Aug	+ 2.3	+ 2.4	+ 2.0	+ 1.8 Jul	+ 5.5	+ 2.5 Jul	+ 2.2
Britain	+ 2.4 Aug*	+ 1.3	+ 2.0	+ 1.9	+ 3.0 Aug	+ 2.8	+ 4.2 Jul†	+ 3.8
Canada	+ 2.0 Jul	+ 2.3	+ 2.1	+ 2.2	– 0.3 Jul	+ 5.5	+ 1.4 Jun	+ 2.5
Denmark	+ 2.2 Aug	+ 1.2	+ 1.6	+ 1.8	+ 5.0 Aug	+ 3.1	+ 2.9 Q2	+ 3.1
France	+ 1.8 Aug	+ 2.4	+ 1.8	+ 1.6	+ 2.9 Jun	+ 2.2	+ 2.9 Q2	+ 2.8
Germany	+ 1.9 Aug	+ 2.0	+ 1.7	+ 1.6	+ 1.9 Aug	+ 4.2	+ 1.3 Jul	+ 0.4
Italy	+ 2.0 Aug	+ 2.3	+ 2.1	+ 1.9	+ 3.6 Jul	+ 3.3	+ 2.8 Jul	+ 3.2
Japan	– 0.3 Jul	– 0.1	– 0.1	+ 0.3	+ 1.7 Aug	+ 1.7	+ 3.7 Jul	+ 1.7
Netherlands	+ 1.8 Aug	+ 1.1	+ 1.4	na	+ 5.6 Jul	+ 5.2	+ 0.9 Aug	+ 1.0
Spain	+ 3.3 Aug	+ 3.3	+ 3.2	+ 2.9	+ 4.6 Jul	+ 4.1	+ 3.4 Q2	+ 3.1
Sweden	+ 0.6 Aug	+ 0.6	+ 0.5	+ 1.3	+ 3.7 Jul	+ 1.9	+ 2.6 Jun	+ 1.6
Switzerland	+ 1.0 Aug	+ 1.0	+ 1.1	+ 1.1	+ 1.0 Aug	+ 1.5	+ 0.9 2004	+ 1.4
United States	+ 3.6 Aug	+ 2.7	+ 3.0	+ 2.7	+ 5.1 Aug	+ 3.4	+ 2.7 Aug	+ 2.2
Euro area	+ 2.2 Aug	+ 2.3	+ 2.1	+ 1.8	+ 4.0 Jul	+ 2.9	+ 2.3 Q2	+ 2.1
MORE COUNTRIES	Data for the countries below are not provided in printed editions of *The Economist*							
Finland	+ 0.9 Aug	+ 0.4	na	na	+ 3.8 Aug	+ 1.8	+ 4.0 Q2	+ 3.8
Greece	+ 3.7 Aug	+ 2.7	na	na	+ 5.1 Jul	+ 4.7	na	na
Iceland	+ 4.8 Sep	+ 3.4	na	na	+ 4.6 Sep	+ 5.2	+ 6.7 Aug	+ 5.2
Ireland	+ 2.3 Aug	+ 2.6	na	na	+ 0.2 Jul	– 0.7	+ 6.4 Q1	+ 3.9
Luxembourg	+ 2.7 Aug	+ 2.3	na	na	+ 4.2 Jul	+ 9.8	+ 1.6 Jun	+ 2.8
New Zealand	+ 2.8 Q2	+ 2.4	na	na	+ 4.7 Q2	+ 1.5	+ 2.6 Q2	+ 2.3
Norway	+ 1.9 Aug	+ 1.0	na	na	+19.9 Aug	+16.4	+ 3.8 Q2	+ 4.1
Portugal	+ 2.6 Aug	+ 2.3	na	na	+ 4.0 Jul	+ 4.2	– 0.2 Jun	– 0.1

*RPI inflation rate 2.8% in Aug. †May-Jul.

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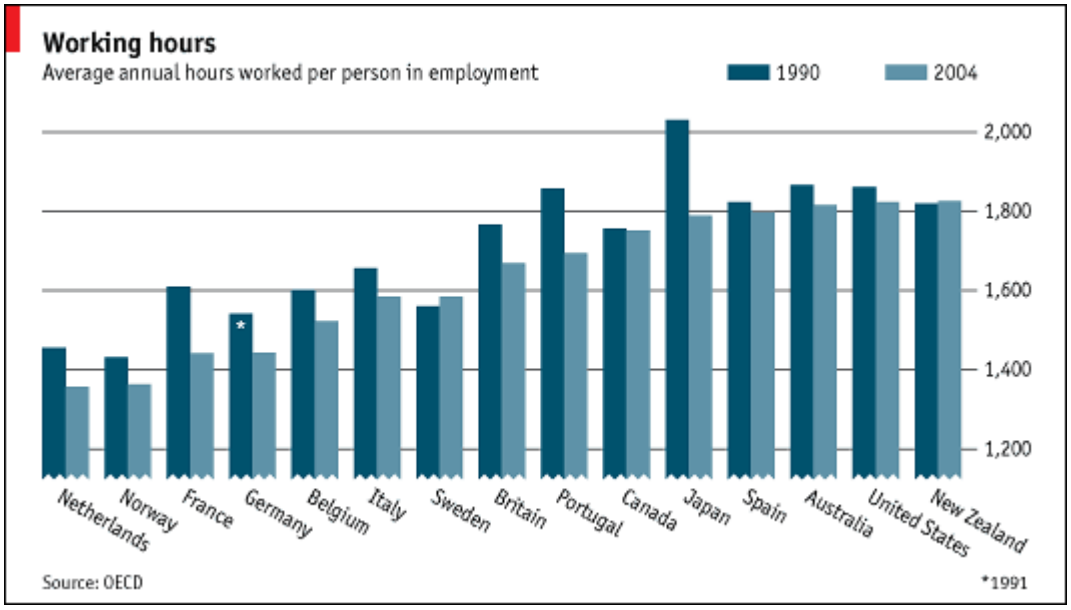
Working hours

Sep 22nd 2005
From The Economist print edition



The average number of hours worked each year has been falling in most rich countries over the past 15 years. In 2004, the Japanese worked 12% fewer hours than in 1990. Most Europeans have also been working less: 10% fewer hours in France and 6% fewer in Germany. Americans and New Zealanders toiled the most in 2004, while the average Dutch worker put in around 25% fewer hours than his American counterpart.

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Money and interest rates

Sep 22nd 2005
From The Economist print edition

	Money supply* % change on year ago			Interest rates % a year (Sep 21st 2005)					
				3-mth money market		2-year	10-year gov't bonds		corporate
	narrow	broad		latest	year ago	gov't bonds	latest	year ago	bonds
Australia	+ 6.5	+ 8.8	Jul	5.62	5.40	5.12	5.22	5.37	6.17
Britain	+ 6.2	+10.2	Aug	4.50	4.91	4.13	4.16	4.82	5.18
Canada	+ 6.5	+10.2	Jul	2.81	2.46	3.10	3.87	4.54	5.11
Denmark	+22.0	+15.7	Jul	2.20	2.25	2.20	2.96	4.05	4.85
Japan	+ 4.4	+ 1.7	Aug	0.02	0.02	0.18	1.37	1.48	1.44
Sweden	+ 3.6	+ 8.1	Jul	1.46	1.98	2.03	2.89	4.27	2.70
Switzerland	+ 0.2	+ 5.6	Aug	0.75	0.66	0.90	1.79	2.62	1.80
United States	+ 1.0	+ 6.1	Aug	3.79	1.78	3.96	4.18	3.99	5.26
Euro area†	+11.1	+ 7.9	Jul	2.14	2.12	2.20	3.00	3.94	3.33

*Narrow: M1 except Britain and Sweden M0, broad: M2 or M3 except Britain M4. † Germany for bonds. Benchmarks: US 30-year 4.46%, Japan No. 272 1.38%. Central bank rates: US fed funds 3.75%, ECB refinancing 2.00%, BOJ overnight call 0.001%, BOE repo 4.5%. Sources: Bank of Canada, Commerzbank, Danske Bank, J.P. Morgan Chase, Stockholmsbörsen, UBS, Global Insight, Westpac, Thomson Datastream. Rates cannot be construed as banks' offers.

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The Economist commodity price index

Sep 22nd 2005
From The Economist print edition

2000=100

	Sep 13th	Sep 20th*	% change on one month	% change on one year
Dollar index				
All items	132.0	131.8	– 0.6	+ 7.6
Food	121.7	121.9	– 1.1	+ 5.5
Industrials				
All	145.4	144.6	– 0.1	+10.0
Nfa†	135.2	134.4	+ 5.3	+ 6.1
Metals	151.0	150.1	– 2.6	+12.1
Sterling index				
All items	109.8	110.7	– 0.9	+ 6.9
Euro index				
All items	99.4	100.1	– 0.4	+ 8.3
Yen index				
All items	135.7	136.3	+ 0.9	+ 9.0
Gold				
$ per oz	446.55	465.95	+ 6.1	+14.1
West Texas Intermediate				
$ per barrel	63.07	66.00	+ 0.9	+40.6

* Provisional. † Non-food agriculturals.

Our commodity-price index was rebased in February 2005.

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Stockmarkets

Sep 22nd 2005
From The Economist print edition

Market indices

	Sep 21st	2005 high	2005 low	% change on one week	% change on record high	% change on Dec 31st 2004 in local currency	% change on Dec 31st 2004 in $ terms
Australia (All Ordinaries)	4,501.8	4,527.2	3,905.5	+ 0.6	- 0.6	+11.1	+ 9.4
Austria (ATX)	3,399.5	3,430.3	2,415.0	- 0.2	- 0.9	+39.8	+25.8
Belgium (Bel 20)	3,284.6	3,314.8	2,958.8	+ 0.6	-10.8	+12.0	+ 0.7
Britain (FTSE 100)	5,369.7	5,429.7	4,783.6	+ 0.4	-22.5	+11.5	+ 5.3
Canada (Toronto Composite)	10,961.6	11,024.7	9,006.2	+ 0.3	- 3.8	+18.5	+21.7
Denmark (KBX)	339.9	341.9	257.8	+ 0.8	- 0.6	+31.8	+18.3
France (SBF 250)	3,127.8	3,167.8	2,633.6	+ 0.2	-28.8	+18.7	+ 6.8
(CAC 40)	4,468.1	4,531.8	3,816.1	- 0.1	-35.5	+16.9	+ 5.2
Germany (DAX)*	4,875.2	5,005.9	4,178.1	- 0.7	-39.6	+14.5	+ 3.0
Italy (S&P/MIB)	34,419.0	34,555.0	30,645.0	+ 0.3	-31.3	+11.4	+ 0.2
Japan (Nikkei 225)	13,196.6	13,196.6	10,825.4	+ 2.8	-66.1	+14.9	+ 5.8
(Topix)	1,357.7	1,357.7	1,109.2	+ 3.5	-52.9	+18.1	+ 8.8
Netherlands (AEX)	396.5	401.6	347.0	+ 0.7	-43.5	+13.9	+ 2.5
Spain (Madrid SE)	1,135.0	1,142.9	950.9	+ 0.7	- 1.0	+18.3	+ 6.5
Sweden (Affarsvarlden Gen)	262.4	264.7	218.9	- 0.8	-34.4	+18.6	+ 3.1
Switzerland (Swiss Market)	6,761.0	6,835.7	5,669.6	+ 0.4	-19.6	+18.8	+ 6.3
United States (DJIA)	10,386.1	10,940.6	10,012.4	- 1.5	-11.4	- 3.7	- 3.7
(S&P 500)	1,211.0	1,245.0	1,137.5	- 1.3	-20.7	- 0.1	- 0.1
(NASDAQ Comp)	2,108.3	2,218.2	1,904.2	- 1.9	-58.2	- 3.1	- 3.1
Europe (FTSEurofirst 300)†	1,205.4	1,218.1	1,038.6	nil	-29.3	+15.7	+ 4.1
Euro area (FTSE Euro 100)†	1,017.0	1,030.3	894.4	- 0.2	-34.4	+12.9	+ 1.5
World (MSCI)‡	1,211.0	1,225.6	1,115.0	- 0.4	-16.4	+ 3.6	+ 3.6
World bond market (Citigroup)††	647.2	662.3	626.9	nil	- 2.3	- 2.8	- 2.8

*Total return index. †In euro terms. ‡Morgan Stanley Capital International index includes individual markets listed above plus eight others, in $ terms. ††Citigroup World Government Bond Index, total return, in $ terms.

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Trade, exchange rates and budgets

Sep 22nd 2005
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	Trade balance*, $bn latest 12 months		Current-account balance $bn latest 12 mths		The Economist poll % of GDP, forecast 2005	2006	Exchange rate trade-weighted† 2000=100 Sep 21st	year ago	Currency units per $ Sep 21st	year ago	per £	per euro	per ¥100	Budget balance % of GDP 2005‡
Australia	− 16.5	Jul	− 43.1	Q2	− 5.9	− 5.5	118.9	109.5	1.30	1.42	2.35	1.58	1.17	+ 0.9
Austria	− 1.5	Jun	nil	Jul	− 0.4	− 0.3	103.9§	104.0	0.82	0.82	1.48	–	0.74	− 2.0
Belgium	+ 15.4	Jul	+ 12.2	Mar	+ 2.8	+ 2.7	104.4§	104.4	0.82	0.82	1.48	–	0.74	− 0.5
Britain	−114.3	Jul	− 44.0	Q1	− 2.4	− 2.5	100.2	99.8	0.55	0.56	–	0.67	0.50	− 2.9
Canada	+ 46.5	Jul	+ 16.3	Q2	+ 1.4	+ 1.2	123.7	112.6	1.17	1.28	2.12	1.43	1.05	+ 1.2
Denmark	+ 9.8	Jul	+ 11.5	Jul	+ 2.1	+ 1.9	105.6	106.0	6.10	6.08	11.1	7.46	5.49	+ 1.8
France	− 27.8	Jul	− 24.1	Jul	− 0.7	− 0.5	106.9§	107.0	0.82	0.82	1.48	–	0.74	− 3.0
Germany	+198.8	Jul	+110.5	Jul	+ 3.6	+ 3.4	104.6§	104.7	0.82	0.82	1.48	–	0.74	− 3.5
Italy	− 6.1	Jun	− 26.0	Jul	− 1.3	− 1.5	76.5§	76.6	0.82	0.82	1.48	–	0.74	− 4.4
Japan	+110.4	Jul	+165.8	Jul	+ 3.4	+ 3.3	85.7	86.5	111	111	202	136	–	− 6.1
Netherlands	+ 40.0	Jul	+ 28.3	Q2	+ 3.7	+ 3.6	103.9§	103.9	0.82	0.82	1.48	–	0.74	− 2.2
Spain	− 89.4	Jun	− 75.2	Jun	− 5.4	− 5.5	77.2§	77.2	0.82	0.82	1.48	–	0.74	+ 0.5
Sweden	+ 22.2	Jul	+ 27.9	Q2	+ 6.7	+ 6.2	95.8	99.6	7.64	7.40	13.9	9.35	6.87	+ 0.8
Switzerland	+ 7.0	Jul	+ 40.2	Q1	+11.4	+11.0	106.3	106.9	1.27	1.26	2.30	1.55	1.14	− 1.0
United States	−730.7	Jul	−749.7	Q2	− 6.3	− 6.3	84.6	86.6	–	–	1.81	1.22	0.90	− 4.1
Euro area	+ 61.5	Jun	+ 10.3	Jul	+ 0.3	+ 0.2	115.5	116.0	0.82	0.82	1.48	–	0.74	− 2.8
MORE COUNTRIES	Data for the countries below are not provided in printed editions of *The Economist*													
Finland	+ 12.0	Jul	+ 6.4	Jul	na	na	81.5§	81.6	0.82	0.82	1.48	–	0.74	+ 1.3
Greece	− 33.6	Jun	− 15.7	Jul	na	na	99.9§	99.9	0.82	0.82	1.48	–	0.74	− 3.8
Iceland	− 1.0	Jul	− 1.6	Q2	na	na	102.8**	95.4	61.5	71.4	111	75.2	55.3	+ 1.1
Ireland	+ 40.2	Jul	− 3.1	Q1	na	na	94.1§	94.0	0.82	0.82	1.48	–	0.74	− 0.7
Luxembourg	− 4.4	Jun	+ 3.0	Q1	na	na	104.4§	104.4	0.82	0.82	1.48	–	0.74	− 0.8
New Zealand	− 3.7	Jul	− 8.2	Q2	na	na	136.5	131.2	1.43	1.51	2.59	1.75	1.28	+ 3.2
Norway	+ 43.3	Aug	+ 40.8	Q2	na	na	111.9	103.9	6.38	6.84	11.6	7.80	5.74	+ 14.4
Portugal	− 22.3	Jun	− 15.7	Jul	na	na	94.1**	93.6	0.82	0.82	1.48	–	0.74	− 5.3

*Merchandise. Australia, Britain, France, Canada, Japan and United States imports fob, exports fob. All others cif/fob. †Bank of England except §IMF, July average. ‡OECD forecast. **IMF, May average.

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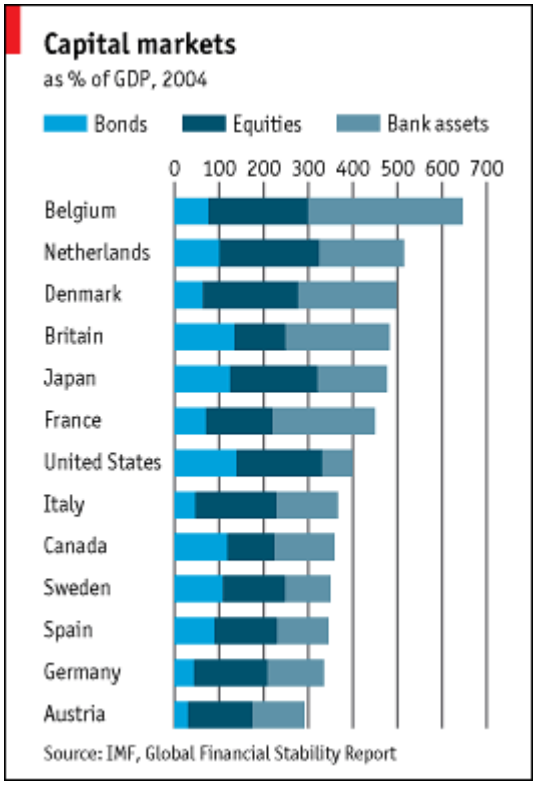
Capital markets

Sep 22nd 2005
From The Economist print edition



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Overview

Sep 22nd 2005
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In **Argentina**, GDP growth accelerated to 10.1% in the year to the second quarter. Over the same period, it slowed to 4.2% in **Turkey**.

In the year to August, industrial-production growth in **Poland** quickened to 4.6%, while slackening in **Russia** to 3.4%.

Israel's industrial-output growth picked up to 3.6% in the year to July. **Peru's** slowed to 4.6% in the same period.

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Mexico

Sep 22nd 2005
From The Economist print edition

By most measures, Mexico's economy is in good shape. Inflation is falling, output is growing steadily and, according to the OECD's latest economic survey, there are no serious macroeconomic problems on the horizon. The OECD expects Mexico's economy to expand by around 4% in both 2005 and 2006, well above the average pace of GDP growth in the so-called “rich-man's club”. But given the rapid rate of expansion in Mexico's population, 4% GDP growth is still too low to shrink the gap in living standards with other OECD countries, and is lower than the 1996-2000 average of 5.5%.

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Economy

Sep 22nd 2005
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	% change on year ago						Latest 12 months, $bn				Foreign reserves* $bn, latest	
	GDP		Industrial production		Consumer prices		Trade balance		Current account			
China	+ 9.5	Q2	+16.0	Aug	+ 1.3	Aug	+93.1	Aug	+68.7	2004	711.0	Jun
Hong Kong	+ 6.8	Q2	– 0.1	Q2	+ 1.3	Jul	– 9.6	Jul	+18.5	Q1	122.3	Aug
India	+ 7.0	Q1	+ 6.7	Jul	+ 4.1	Jul	–34.7	Aug	– 6.4	Q1	133.6	Aug
Indonesia	+ 5.5	Q2	+ 7.3	Jul	+ 8.3	Aug	+27.8	Jul	+ 7.8	Q1	31.0	Jul
Malaysia	+ 4.1	Q2	+ 0.9	Jul	+ 3.7	Aug	+23.6	Jul	+16.7	Q1	78.0	Jul
Philippines	+ 4.8	Q2	– 0.1	Jun	+ 7.2	Aug	– 0.8	Jun	+ 2.9	Mar	15.3	Aug
Singapore	+ 5.2	Q2	+ 5.9	Jul	+ 0.1	Jul	+17.4	Aug	+32.5	Q2	116.4	Aug
South Korea	+ 3.3	Q2	+ 7.0	Jul	+ 2.0	Aug	+26.0	Aug	+21.3	Jul	206.6	Aug
Taiwan	+ 3.0	Q2	– 1.1	Jul	+ 3.6	Aug	+ 1.7	Aug	+13.3	Q2	254.1	Aug
Thailand	+ 4.4	Q2	+ 4.7	Jul	+ 5.6	Aug	– 7.3	Jul	– 2.2	Jul	47.3	Jul
Argentina	+10.1	Q2	+ 6.0	Jul	+ 9.7	Aug	+11.2	Jul	+ 2.8	Q1	24.4	Jul
Brazil	+ 3.9	Q2	+ 0.5	Jul	+ 6.0	Aug	+40.1	Aug	+12.5	Aug	54.6	Aug
Chile	+ 6.5	Q2	+ 4.4	Jul	+ 3.0	Aug	+ 8.7	Aug	+ 0.6	Q2	15.8	Aug
Colombia	+ 3.6	Q1	+ 3.0	Jun	+ 4.9	Aug	+ 1.6	May	– 0.8	Q1	14.9	Aug
Mexico	+ 3.1	Q2	– 1.1	Jul	+ 4.0	Aug	– 9.6	Jul	– 8.4	Q2	66.4	Jul
Peru	+ 4.9	Jul	+ 4.6	Jul	+ 1.2	Aug	+ 3.8	Jun	+ 0.4	Q2	12.8	Aug
Venezuela	+11.1	Q2	+ 6.2	Jun	+14.8	Aug	+24.7	Q2	+17.7	Q2	23.1	Jun
Egypt	+ 4.7	Q4	+ 3.3	2004†	+ 4.7	Jun	– 9.5	Q1	+ 4.4	Q1	18.5	Jul
Israel	+ 4.8	Q2	+ 3.6	Jul	+ 1.6	Aug	– 7.7	Aug	+ 1.3	Q2	27.8	Aug
South Africa	+ 4.5	Q2	+ 2.4	Jul	+ 3.4	Jul	– 2.3	Jul	– 8.5	Q1	17.2	Aug
Czech Republic	+ 5.1	Q2	+11.2	Jul	+ 1.7	Aug	+ 1.3	Jul	– 4.1	Q2	30.2	Aug
Hungary	+ 4.1	Q2	+ 8.4	Jul	+ 3.6	Aug	– 3.4	Jul	– 9.2	Q1	18.0	Aug
Poland	+ 2.8	Q2	+ 4.6	Aug	+ 1.6	Aug	– 3.3	Jul	+ 0.3	Jul	39.4	Jul
Russia	+ 6.1	Q2	+ 3.4	Aug	+12.4	Aug	+110.6	Jul	+69.2	Q1	146.0	Aug
Turkey	+ 4.2	Q2	– 0.3	Jul	+ 7.9	Aug	–38.9	Jul	–20.0	Jul	42.9	Jul
MORE COUNTRIES	Data for the countries below are not provided in printed editions of *The Economist*											
Estonia	+10.0	Q2	+11.1	Jul	+ 4.2	Aug	– 2.3	Jun	– 1.4	Jul	1.8	Jul
Latvia	+11.6	Q2	+ 5.0	Jul	+ 6.1	Aug	– 2.7	Jul	– 1.5	Jul	2.1	Jul
Lithuania	+ 8.0	Q2	na		+ 1.3	Aug	– 3.1	Jul	– 1.4	Jul	3.4	Jul
Slovakia	+ 5.1	Q2	+ 4.7	Jul	+ 2.0	Aug	– 2.0	Jul	– 2.3	May	15.3	Jul
Slovenia	+ 5.2	Q2	+ 3.5	Jul	+ 2.0	Aug	– 1.3	Jul	nil	Jul	8.1	Jun
Pakistan	+ 8.4	2005†	+13.6	Apr	+ 8.4	Aug	– 7.3	Aug	– 1.5	Q2	10.4	May
Saudi Arabia	+ 5.2	2004	na		+ 0.6	Jun	+84.9	2004	+51.5	2004	24.8	Jul

*Excluding gold, except Singapore; IMF definition. †Year ending June.
Sources: National statistics offices, central banks and stock exchanges; Thomson Datastream; Reuters; WM/Reuters; Hong Kong Monetary Authority; Centre for Monitoring Indian Economy; Bank Leumi le-Israel; Standard Bank Group.

Financial markets

Sep 22nd 2005
From The Economist print edition

	Currency units			Interest rates	Stockmarkets	% change on		
	per $		per £	short-term	Sep 21st		Dec 31st 2004	
	Sep 21st	year ago	Sep 21st	% a year		one week	in local currency	in $ terms
China	8.09	8.28	14.7	4.38	1,248.2	-2.4	- 6.2	- 4.0
Hong Kong	7.76	7.80	14.1	3.95	15,223.6	+0.9	+ 7.0	+ 7.1
India	43.9	45.8	79.5	5.10	8,487.1	+3.6	+ 28.5	+ 27.4
Indonesia	10,215	9,163	18,516	12.89	1,044.1	-1.4	+ 4.4	- 5.1
Malaysia	3.77	3.80	6.83	2.90	922.6	+0.9	+ 1.7	+ 2.5
Philippines	56.3	56.4	102.1	7.31	1,959.2	+2.3	+ 7.5	+ 7.1
Singapore	1.68	1.69	3.04	2.21	2,298.7	-0.6	+ 11.3	+ 8.1
South Korea	1,030	1,148	1,866	3.79	1,196.7	+2.2	+ 33.6	+ 34.3
Taiwan	33.1	33.8	60.0	1.55	6,067.3	-1.3	- 1.2	- 5.4
Thailand	41.0	41.4	74.3	3.95	721.2	+0.5	+ 7.9	+ 2.2
Argentina	2.91	3.00	5.28	6.69	1,659.0	+2.5	+ 20.6	+ 23.0
Brazil	2.29	2.87	4.14	19.51	30,837.0	+6.2	+ 17.7	+ 36.8
Chile	535	613	969	3.96	10,067.3	+1.8	+ 12.3	+ 16.7
Colombia	2,293	2,560	4,157	6.88	6,825.6	+0.8	+ 57.1	+ 61.1
Mexico	10.8	11.4	19.5	9.06	15,734.4	+3.4	+ 21.8	+ 25.9
Peru	3.30	3.35	5.98	2.98	4,948.0	+1.8	+ 33.4	+ 32.4
Venezuela	2,754§	2,536§	4,992	11.00	21,524.3	+1.0	- 28.1	- 32.7
Egypt	5.77	6.23	10.45	8.94	44,856.4	+0.5	+ 82.5	+ 92.0
Israel	4.58	4.49	8.29	3.73	735.8	-1.3	+ 14.3	+ 7.9
South Africa	6.37	6.51	11.6	7.05	16,435.2	+2.8	+ 29.9	+ 14.8
Czech Republic	24.1	25.7	43.7	1.80	1,432.5	+3.0	+ 38.8	+ 28.7
Hungary	202	201	365	5.85	22,947.0	+0.9	+ 55.7	+ 39.5
Poland	3.18	3.54	5.77	4.48	33,535.2	+3.3	+ 25.9	+ 18.5
Russia	28.4	29.2	51.4	13.00	960.5‡	+7.2	+ 60.0	+ 56.4
Turkey	1.34	1.51	2.43	16.04	33,863.8	+4.1	+ 35.6	+ 36.6
EM (MSCI)*	1.00	1.00	1.81	na	650.7	+2.4	+ 20.0	+ 20.0
EMBI+†	1.00	1.00	1.81	na	359.8	+0.7	+ 9.2	+ 9.2

*Emerging Mkts. †J.P. Morgan Chase's Emerging Mkts Bond Index Plus. ‡In $ terms. §Floating exchange rate.
Sources: National statistics offices, central banks and stock exchanges; Thomson Datastream; Reuters; WM/Reuters; Hong Kong Monetary Authority; Centre for Monitoring Indian Economy; Bank Leumi le-Israel; Standard Bank Group.

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